CORPORATE GOVERNANCE MODEL OF STATE-HELD LISTED COMPANIES IN CHINA

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The remarks and comments of three anonymous examiners concerning previous versions of the text, which contributed significantly to improving my work, are also gratefully acknowledged.

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Summary

This thesis explores the corporate governance model in state-held listed companies in China. The following research questions are addressed: (1) What is the current corporate governance model of state-held listed companies in China? (2) Are state-held listed companies well governed under the current corporate governance model? (3) If the answer to the second research question is negative, then is there any other model under which state-held listed companies may be well governed?

The "state-controlled" model that directs the corporate governance of state-held listed companies in China has common elements with the bank-based model, under which banks play a predominant role in corporate financing in a weak securities market. It also contains the employee participation element of the stakeholder model, but the trade unions in China are still strictly controlled by the government. The state-controlled model relates to the issue of how the state assets of China were and are managed, which is at the very "intersection" of political control and economic reform. It is the state-controlled model that has led to China's unique earmarks of two-tier share market and two-tier board structure.

This thesis argues that state-held listed companies in China are not well-governed under the state-controlled model, because it fails to protect minority shareholders and the two-tier board structure does not perform efficiently due to poor law enforcement arising from corruption in China. The state-controlled listed companies would be better governed under a "law-controlled model" rather than a "state-controlled model." This new model would improve the corporate governance of state-held listed companies by virtue of implementing the rule of law in China (or at least the "thin" rule of law in transition from "rule by law"). Failing that, the practical issues arising from "state-controlled model" could be addressed by (i) reforming the laws; and (ii) enforcing the laws (including improving the anti-corruption supervisory regime and effecting judicial independence).

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Summary of Amendments

To be tasked with "major amendment" is a humbling experience. Approved by Faculty of Law, I have read through the feedback from the three examiners and have found their comments to be quite insightful in guiding the re-organization of my thesis and in making the necessary amendments. I would like to express my sincere gratitude to the examiners for the effort they gave put into my review, and I hope my amended thesis will match their expectations.

Corporate governance is a highly topical issue these days. The thesis has been re-drafted following extensive consultation with government officials, senior executives of state-owned enterprises and law practitioners in China. On the one hand, I intended to provide a series of thoughtful observations based on a broad range of literature; on the other hand, because of the enormity of the subjects involved, it is unrealistic to attempt significantly more than a thesis-length treatment systematically and vigorously exploring the practice of state-held listed companies from the perspective of corporate governance.

This revised thesis has undergone some major changes. The research topic has been explicitly identified to be the state-held listed companies, the organization of the thesis has been adjusted and made more coherent and the arguments have been clearly tied-in with each other between chapters. Furthermore, an increasing number of statutes and regulations are supplemented in the amendments, which are set out at the Appendix hereto this summary.

Making these amendments is, admittedly, an uphill task, one which has taken up quite a bit of my time this past year. I was fortunate to have the guidance of my supervisor for this time. Currently, I lead the legal team of a global oil and gas company, one which is a state-held listed company headquartered in Beijing. I have tried my best to contribute my experience and knowledge in managing the enormous and varied workload of a regional legal role to this research in my own way.

I will summarize the amendments chapter-by-chapter, in comparison with the previously-submitted first edition (referred to as "**first version**"):

"Corporate Governance Model of State-Held Listed Companies in China"

The title of the revised edition specifies the issue of corporate governance of state-held listed companies in the context of China, on which the research questions and arguments of this thesis are based. The key words are "corporate governance model", "state-held listed companies" and "China".

Chapter I – Introduction

Added:

1. The legal framework (section 1.1.2/A) is re-drafted based on Chapter III of the first version;

2. Two main types of public listed companies in China (section 1.1.2/B) are re-drafted based on Chapter II of the first version;

3. Research perspective is identified in section 1.2 comprising: 1.2.1 research questions and arguments and 1.2.2 research scope. Three research questions are addressed: (1) What is the current corporate governance model of state-held listed companies in China (discussed in Chapters II, III, IV and V)?; (2) Are state-held listed

companies well governed under the current corporate governance model (elaborated in Chapters IV, V and VI)?; (3) If the answer to the second research question is negative, then is there any other model under which state-held listed companies may be well governed (to be proposed in Chapter VI)?

Revised:

1. Research methodology (section 1.3.2), feasible recommendations (section 1.3.3), and organization and framework of thesis (section 1.4) are revised accordingly;

2. The terminology of "public listed company", "state-held listed company", "non-tradable shares" and "controlling shareholder" are re-defined in order to fix the problem of the language being too "loose";

3. The figures in Table 1.4 "Overview of the Public Listed Companies in China" have been updated.

Removed:

1. The section of literature review, most of which has been redistributed to other relevant sections of the amended thesis;

2. The survey results on East Asian Corporations by Claressens, Djankov & Lang have been removed from Table 1.3 as it appeared in Table 2.4 of Chapter II in the first version.

Chapter II – Corporate Governance Model

Added:

1. This Chapter is re-drafted and developed from Chapter V of the first version. It sets the scene by sketching the state-controlled model into its elements reflected in the bank-based model and stakeholder model respectively;

2. The stakeholder model is re-drafted based on the section of stakeholder in Chapter IV of the first edition.

Chapter III – Underpinnings of State-Controlled Model

Added:

This is a brand-new chapter, which is re-drafted and developed from chapters III and V of the first version. It gives an overview of how the state-controlled model of state-held companies in China is underpinned by both political control and SOE's reform. In particular, it explores this at the macro-level by focusing on how the state assets of China are administered.

Chapter IV – The Two-tier Shareholding Structure

Added:

1. Two types of ownership structures (section 4.1.1) are re-drafted based on Chapter II of the first version;

2. Two-tier shareholding structure (section 4.1.2) is re-drafted based on Chapter II of the first version;

3. The Reform of Sales of Non-Tradable Shares of Public Listed Companies (section 4.2) is re-drafted based on Chapter II of the first version;

4. Meanwhile, the statistics of post-reform (section 4.2.3) have been updated;

5. The final section of practical issues arising out of the state-controlled ownership under the two-tier shareholding structure (section 4.4) is a brand-new section, in which the cumulative voting system has been analyzed in detail (section 4.4.3);

6. This Chapter also offers insights as to the derivative actions by exploring both legislation and judicial application (section 4.4.4). In particular, it analyzes how the derivative actions come to be accepted by all the people's courts in China;

7. The statistics from the Chinese law database of "LawinfoChina" <http://www.lawinfochina.com> are used to explain the limited number of derivative

suits in the context of listed companies in China.

Revised:

The empirical study (section 4.4.1) and controlling shareholders' tunneling behaviors (section 4.4.2) are re-drafted.

Chapter V – Two-tier Board Structure

Added

This Chapter is re-drafted and developed from the section of "board of directors" in Chapter IV of the first version.

Revised:

1. The internal control (section 5.1.2) is discussed in far greater detail;

2. The director's duties in the context of China are analyzed by exploring both legislation and judicial application in section 5.1.3/B(C);

3. The statistics from the Chinese law database of "LawinfoChina" are used to explain the loyalty duty and duty of diligence;

4. The independent director (section 5.2.1) and supervisory board (section 5.2.2) are re-organized to be contrasted with the United States and Germany in historical development respectively;

5. The similarities and differences of supervisors, supervisory boards and codetermination in Germany and China are re-organized and highlighted in the section 5.2.2;

6. The final section of practical issues arising out of the state-controlled ownership under the two-tier boards (section 5.3) is a brand-new section. The author tries to argue that the state-held listed companies in China are not well governed under the two-tier

shareholding structure where the state is the controlling shareholder because of the following two issues: 1. The supervisory board is not needed with the presence of independent directors; 2. The independent directors could not perform their third role in China – protecting minorities.

Chapter VI – Reflections on the State-Controlled Model

Added:

This Chapter is a brand-new chapter, and is re-drafted and developed from chapters III, V and VI of the first version.

This chapter is organized and structured by exploring the following issues based on the research of Chapters IV and V: 6.1 Are state-held listed companies in China well governed under the state-controlled model? 6.2 If not, why the corporate governance of state-held listed companies in China fails to work effectively under the state-controlled model? 6.3 State-held listed companies could be well governed in other jurisdictions? 6.4 How corporate governance in state-held listed companies might work? I draw conclusions to these issues at the end of the chapter.

In this Chapter, the author also examines the challenges in relation to non-enforcement, corruption, political control and judicial non-independence.

Chapter VII – Final Reflections

Added:

1. The positive roles that Asian Development Bank (ADB) and International Finance Corporation (IFC) play in the corporate governance of China are moved from Chapter VI of the first edition to Chapter VII in this edition.

Revised:

1. The title of this Chapter has been amended to “Final reflections” where it was previously titled “Conclusion”.

Appendix

International document

OECD Guidelines on Corporate Governance of State-Owned Enterprises (2005)

Statutes

Law of the People's Republic of China on the State-Owned Assets of Enterprises, with effect from October 1, 2007;

Law of the People's Republic of China on Administrative Supervision, with effect from May 9, 1997.

Civil Procedure Law of PRC (revised 2007), with effect from 28 October 2007;

Criminal Procedure Law of PRC (revised 1996), with effect from 17 March 1996;

Administrative Procedure Law of PRC, with effect from 1 October 1990;

Law of Mediation and Arbitration on Labor Disputes, with effect from 1 May 2008.

Regulations

Opinions on the Determination of State-owned Enterprises, issued by Ministry of Finance, with effect from 23 April, 2003;

Notice of Establishing Information Reporting System concerning the Operations of State-held Listed Companies, issued by the SASAC, with effect from 19 January, 2010;

Notice of Interim Measures for the Administration of the Collection of Proceeds from State-owned Capital of Central Enterprises, issued by Ministry of Finance and SASAC, with effect from 11 December, 2007;

Guiding Opinions of Share-trading Reform of Listed Companies, issued by CSRC, SASAC, Ministry of Finance, People's Bank of China and Ministry of Commerce, with effect from 23 August, 2005;

Provisions of Reinforcing and Improving the Supervisory Board of State-owned Enterprises, issued by the SASAC, with effect from 28 September, 2006;

Guidelines of Appointment and Conduct of Directors in the Public Listed Companies, issued by Shanghai Stock Exchange, with effect from 25 August, 2009;

Regulation of Non-executive Directors in the Experimental State-owned Enterprises, issued by the SASAC, with effect from 13 October 2009;

Guidelines of Independent Director and Outside Supervisor in the Joint-Stock Commercial Bank, issued by People's Bank of China, with effect from 23 May, 2002;

Interim Measures for the Administration of Insurance Companies' Independent Directors, issued by the China Insurance Regulatory Commission, with effect from 6 April, 2007;

Provision on Strengthening the Protection of the Rights and Interests of the General Public Shareholders, issued by CSRC, with effect from 7 December, 2004;

Provisions on Several Issues Concerning the Application of the PRC Company Law (Interpretations of *PRC Company Law*), issued by the Supreme People's Court on 28 April 2006, with effect from 9 May 2006;

Several Opinions on Reinforcing the Supervision over the State-assets of Local Governments, issued by the SASAC on 19 September 2009;

Interim Measures for the Administration of State-owned Shareholders' Transfer of Their Shares of Listed Companies, issued by the State-owned Assets Supervision and Administration Commission of the State Council and the China Securities Regulatory Commission on 30 June 2007, with effect from 1 July 2007;

Trial Measures of Implementing Equity Incentive Plans by State Held Listed Companies (Domestic), issued by the Ministry of Finance and SASAC, with effect from 30 September 2006.

Chapter I Introduction

> "Corporate governance is a permanent topic in the capital market and is a long-term task of the China's capital market."
>
> Mr. Shang Fulin, Chairman of the China Securities Regulatory Commission

1.1 Research Background

1.1.1 World-wide overview

Corporate governance now plays an increasingly important role in explaining economic behavior and performance, reflecting developments in international investment, national trade and corporate operations.[1] Becht *et al.* (2002) identify six reasons why corporate governance has become a prominent topic in the past few decades: "(i) world-wide wave of privatization; (ii) pension fund reform and the growth of private economic savings; (iii) takeover wave; (iv) deregulation and integration of capital markets; (v) the late 1990s Asian financial crisis; (vi) a series of corporate scandals in the USA, Europe, and Asia."[2]

In recent decades, numerous academic scholars, domestic corporate governance codes, and international organizations have given their own interpretations of corporate governance, and extensive research on corporate governance has been

[1] The Credit Lyonnais Securities Asia (CLSA) report "Saints and Sinners – Who's Got Religion?" (2001) finds that there is a close relationship between corporate governance and financial ratios (in terms of the share price performance of large stocks). Available at: www.webb-site.com/articles/Saints&Sinners.pdf.

[2] Becht, Marco, Patrick Bolton & Ailsa Röell, "Corporate Governance and Control" (October 2002) ECGI - Finance Working Paper No. 02/2002, at 10.

carried out in the fields of economics, management, and law.[3]

1.1.2 China

A. Legal framework

In China, there are two main types of corporate law: statutes and regulations. A series of statutes (or several sections of the statutes) coupled with regulations constitute the complete legal framework. Statutes are promulgated by the legislatures, which include the National People's Congress and local People's congresses. Regulations are issued by the Central Government, the State Council, or its Ministries (such as the China Securities Regulatory Commission or the Ministry of Commerce),

[3] UK Cadbury Report (1992) states that: "Corporate governance is the system or process by which companies are directed and controlled." See Cadbury, A. Report of the Committee on the Financial Aspects of Corporate Governance (London, 1992). Shleifer & Vishny (1997) define corporate governance as "an institutional arrangement" for value maximization by which "suppliers of finance to corporations assure themselves of getting a proper return on their investment". See Shleifer, Andrei & Vishny, Rober, "A Survey of Corporate Governance" (1997) 52 Journal of Finance 737. The Basel Committee Report on Corporate Governance (1999) suggests a multi-actor approach, through which "boards of directors and senior management" as the main responsibility for corporate governance and promote it "for governments through laws and regulations, for securities regulators and stock exchanges through disclosure and listing requirements, and for accounting professionals through audit standards on communications to boards of director and senior management and through publication of sound practices". See Kern Alexander, Rahul Dhumale & John Eatwell, *Global Governance of Financial Systems: the International Regulation of Systematic Risk* (Oxford University Press, 2006) at 241. For China's contemporary academia, some noted economists have identified corporate governance in their writings. Wu Jinglian (1994) asserts that corporate governance is an "organizational structure", consisting of the owner, board of directors and senior managers. "A check and balance relationship is formed within that structure, in which the owner entrusts his capital to the board. The board is the highest level of decision-making of the company". See Wu, Jinglian, Xiandai Gongsi Yu Quye Gaige (Modern Company and Enterprise Reform) (Tianjin People Press, 1994) (in Chinese). Lin Yifu *et al.* (1997) refer to corporate governance as a series of institutional arrangement for owners of the company to monitor and control the management and performance. See Lin Yifu *et al*., *Information Sufficiency and SOE Reform* (Shanghai People Press, 1997) (in Chinese).

and by the local governments under authorization by law.

The *Company Law* (Revised 2006)[4] and *Securities Law* (Revised 2006)[5] are the primary statutes related to corporate governance. Other statutes may apply to industry-relevant companies, including the *Commercial Bank Law* (2003)[6] and the *Insurance Law* (2002)[7], and to specific events, such as asset security (*Property Law* (2007)[8]) or liquidation (*Enterprise Bankruptcy Law* (2006)[9]).

The regulations set out rules for various corporate operations, which are mostly applied to public listed companies, including corporate governance in the *Code of Corporate Governance of Public Listed Company* ("*CG Code*") (2002)[10]; independent directorship in the *Guideline for the Establishment of Independent Director System in Public listed Companies* (2001) ("*ID Guideline*")[11]; incorporation in the *Regulation*

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[4] It is adopted at the Fifth Session of the Standing Committee of the Eighth National People's Congress on December 29, 1993. It was revised for the first time on December 25, 1999, revised for the second time on August 28, 2004, and revised for the third time at the 18th Session of the 10th National People's Congress of the People's Republic of China on October 27, 2005. The revised Company Law comes into force on January 1, 2006.

[5] It is adopted at the 6th Meeting of the Standing Committee of the 9th National People's Congress on December 29, 1998, and is revised at the 18th Meeting of the Standing Committee of the Tenth National People's Congress of the People's Republic of China on October 27, 2005. The revised Securities Law comes into force on January 1, 2006.

[6] It is adopted at the 13th Session of the Standing Committee of the Eighth National People's Congress on May 10, 1995, and is revised by the Sixth Session of the Standing Committee of the Tenth National People's Congress on December 27, 2003. It comes into force on July 1, 1995.

[7] It is adopted at the 14th meeting of the Standing Committee of the Eighth National People's Congress on June 30, 1995, and is revised by the 30th Meeting of the Standing Committee of the Ninth People's Congress. It comes into force on October1, 1995.

[8] It is adopted at the 5th Session of the 10th National People's Congress on March 16, 2007. It comes into force on October 1, 2007.

[9] It is adopted at the 23rd meeting of the Standing Committee of the 10th National People's Congress on August 27, 2006. It comes into force on June 1, 2007.

[10] It is issued by the China Securities Regulatory Commission and State Economic and Trade Commission (in 2003 it was changed to the Ministry of Commerce) of the State Council on January 7, 2002.

[11] It is issued by the China Securities Regulatory Commission on August 16, 2001.

on Administration of Company Registration (Revised 2005)[12]; disclosure in the *Administrative Measures for the Disclosure of Information of Public listed companies* (2007)[13]; and corporate constitutions in the *Guidelines for the Articles of Association of Public listed Companies* (Revised 2006) ("*Articles Guidelines*")[14].

The *PRC Company Law*[15] categorizes two types of company: limited liability companies and joint stock limited companies. In the case of limited liability companies, a shareholder is liable to the company to the extent of the amount of the shareholder's capital contribution. In the case of joint stock limited companies, the total share capital is divided into shares of equal value, and shareholders are liable to the company to the extent of the shares that they hold. Being a joint stock company is one of the requirements for listing on the stock market.[16]

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[12] It is issued by the State Council on December 18, 2005

[13] It is issued by the China Securities Regulatory Commission on January 30, 2007.

[14] It is issued by the China Securities Regulatory Commission on March 16, 2006. The governance practices shall keep the balance between enabling instruments by company itself and mandatory legal provisions. For examples, the "*Articles Guidelines*" provides the sample of articles of association for all public listed companies in China, but it could be supplemented and modified by the companies themselves. The enabling parts in the *Articles Guidelines* concerning corporate governance provide the circumstances in which the company's guarantees should be approved by the Shareholder's general meeting (Article 41), and provide the legal liability of controlling shareholders (Article 39), etc.

[15] *Supra* Note 4, Sec. 3.

[16] *Supra* Note 5, Sec.48 and 50. A joint stock limited company applying for the listing on the stock exchange shall meet the following requirements 1. The stocks shall have been publicly issued upon the approval of the securities regulatory authorities; 2. The total amount of capital stock of the company shall be no less than RMB 30 million; 3. The shares as publicly issued shall reach more than 25% of the total amount of corporate shares; except that the total amount of capital stock of a company exceeds RMB 0.4 billion, the shares as publicly issued shall be no less than 10%; and 4. The company shall not have committed any offence over the latest three years and there is no false record in its financial statements. Where the stock exchange may prescribe higher requirements for listing, they shall be reported to the securities regulatory authorities for approval. The stock exchanges have the authority to examine and approve the application for the listing of any securities.

B. Two main types of public listed companies in China

A "public listed company" is a joint stock limited company that has A and/or B shares listed on either of the two stock exchanges in mainland China — Shanghai Stock Exchange and Shenzhen Stock Exchange[17] — excluding those listed in Hong Kong. In China, public listed companies can be categorized into according to the type of largest controlling shareholder (see Table 1.1) as state-held listed companies or private listed companies.[18]

The controlling shareholder of state-held listed company is the solely state-funded companies or SASAC (or its local branches) on behalf of the state (which holds the "state share") or the state-owned enterprises (exclusive of solely state-funded companies) (which holds the "state-owned legal person share"). The "state share" and "state-owned legal person share" are collectively known as "state-owned shares." The controlling shareholder of the private listed companies is an ordinary person or a non state-owned enterprise.[19]

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[17] *Ibid.* Sec.121.

[18] Shanghai Stock Exchange, *China Corporate Governance Report 2006: The Corporate Governance of State Holding Listed Companies* (Fu Dan University Press, 2006) (in Chinese), at 2.

[19] The "solely state-funded company" is defined in the overview of SOEs in Chapter III. In this thesis, "enterprise" has a wider meaning than company. An enterprise may refer to a legal entity, incorporated under the *Law of the People's Republic of China on Industrial Enterprises Owned by the Whole People* ("*IEOWP Law*", which is not regulated the *PRC Company Law*. An enterprise could also be a non-legal entity, such as partnership, sole proprietorship (i.e. it cannot sue or be sued in its own name and it cannot own or hold any property). The *IEOWP Law* is adopted at the First Session of the Seventh National People's Congress and promulgated by Order No. 3 of the President of the People's Republic of China on April 13, 1988, and effective as of August 1, 1988. The *IEOWP Law* promulgated under the then plan-economy system. The management of an "enterprise owned by the whole people ("*Quanmin Suoyouzhi Qiye*") was appointed and all the major transactions and decisions were to be approved by the government departments who are administrating. Since 2006, the SASAC has directly held shares in state-held listed companies, rather than being an investor in the non-listed holding companies. See *infra* Note 258.

In empirical studies of economics, the controlling shareholder has been defined by La Porta *et al.*[20] and later by Stijn Claessens *et al.*[21] and Faccio and Lang.[22] To measure control, La Porta *et al.* "combine a shareholder's direct (i.e., through shares registered in her name) and indirect (i.e., through shares held by entities that, in turn, she controls) voting rights in the firm . . . [A] firm has a controlling shareholder if the sum of a shareholder's direct and indirect voting rights exceeds an arbitrary cutoff value, which, alternatively, is 20 percent or 10 percent."[23]

The *PRC Company Law* defines the "controlling shareholder" as: (i) a shareholder whose stocks comprise more than 50% of the total equity stocks of a joint stock limited company; or (ii) a shareholder whose shareholding is less than 50% but still larger than that of any other shareholder, so that the largest shareholder is still able to have a predominant influence over corporate matters.[24] That is to say, the

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[20] See La Porta, Lopez-de-Silanes, Shleifer and Vishny, "Corporate Ownership around the World", (1999) 54 J. Fin. 471.

[21] The investigation of ultimate control patterns in 2980 publicly traded companies in nine East Asian economies (Hong Kong, Indonesia, Japan, Korea, Malaysia, the Philippines, Singapore, Taiwan and Thailand), it is concluded that there is large family control in more than half of East Asian corporations, and significant cross-country differences do exist. See Stijn Claessens *et al*., "Who Controls East Asian Corporations?", Working Paper, 1999.

[22] Mara Faccio & Larry H.P. Lang, "The Separation of Ownership and Control: An Analysis ultimate ownership in Western European Corporations", Working Paper, 2000.

[23] *Supra* Note 20, at 478.

[24] *Supra* Note 4, Sec. 217(2). This definition is similar to the stipulation of the American Law Institute: "(a) A 'controlling shareholder' means a person who either alone or pursuant to an arrangement or understanding with one or more other persons: (1)Owns and has the power to vote more than 50 percent of the outstanding voting equity securities of a corporation; or (2)Otherwise exercises a controlling influence over the management or polices of the corporation or the transaction or conduct in question by virtue of the person's position as a shareholder". See American Law Institute, Principles of Corporate Governance: Analysis and Recommendations (St. Paul, Minn.: American Law Institute Publishers, 1994), §1.10; "Controlling shareholder" is defined by the SGX Listing Manual as "a person who: (a) holds directly or indirectly 15% or more of the nominal amount of all voting shares in the company. The Exchange may determine that a person who satisfies this paragraph is

controlling shareholder is restricted by law to being the largest shareholder in the company.

Table 1.1 Classification of Controlling Shareholders

(As at 31 December 2005, there were 831 public listed companies listed on the Shanghai Stock Exchange)[25]

	Holders of State-owned Shares				Holders of Non-State-owned Shares	
	Solely state-funded companies	Central SOEs (under the SASAC[26]	Central SOEs (under Ministries of Central Government except for SASAC)	Local SOEs (under the Local Governments or Local	Ordinary person	Non State-owned enterprise

not a controlling shareholder; or (b) in fact exercises control over a company". The minimum percentage of shareholding for controlling shareholders defined in the Listing Manual by Singapore Stock Exchange is 15%, which falls into the empirical range by the economists, that is, "the sum of a shareholder's direct and indirect voting rights exceeds an arbitrary cutoff value, which, alternatively, is 20 percent or 10 percent". The Section 54(3) of the *Competition Act* of Singapore (Cap.50B) provides that "control shall be regarded as existing if, by reason of securities, contracts or any other means, or any combination of securities, contracts or other means, decisive influence is capable of being exercised with regard to the activities of the undertaking and, in particular, by (a) ownership of, or the right to use all or part of, the assets of an undertaking; or (b) rights or contracts which enable decisive influence to be exercised with regard to the composition, voting or decisions of the organs of an undertaking".

[25] *Supra* Note 18, Table 3.4.

[26] The "SASAC" stands for the State-owned Assets Supervision and Administration Commission. The SASAC is responsible for managing the state assets of China and is a special working commission under the State Council. The central SOEs are typically large-size entities that have bearings on the national economic lifeline, national security, major infrastructure and essential natural resources), accounting for about 40% and 42.6% of assets and profits of all SOEs. The figures are from the Research Bureau of the State-owned Assets Supervision and Administration Commission of PRC, *Reports on the Supervision of State-owned Assets and the Reformation of State-owned Enterprises (2008)* (China Economic Publishing House, 2009) (in Chinese), at 25. China had 159 "Central SOEs", whose total assets exceed RMB 12 trillion by 2006. As at the end of 2008, the number of Central SOEs has been deceased to around 140 by means of restructure or privatization. The target of Chinese government is to have around 80-100 Central SOEs by 2010. See Shanghai Stock Exchange, *China Corporate Governance Report 2009: Market for Corporate Control and Corporate Governance* (Fu Dan University Press, 2009) (in Chinese), at 80.

				SASAC Branches)		
Number	152	129	38	268	221	23
Percent (%)	18.29	15.52	4.57	32.25	26.59	2.77

(A) State ownership distribution in public listed companies

According to the China Corporate Governance Report 2006, of the 835 public listed companies on the Shanghai Stock Exchange, 662 have state-owned shares, which together account for 50.8% of all of the listed shares on the Exchange. In 370 companies (44.31% of all public listed companies), the amount of state-owned shares exceeds 50% of the total shares of those companies.[27] In other words, nearly half of all public listed companies on the Shanghai Stock Exchange are controlled by the state.

(B) Ownership of the controlling shareholder

The comparative statistics in Table 1.2 show that the average shareholding of the largest controlling shareholder in state-held listed companies is 45.13%, which is higher than that in private companies. More remarkable is the ratio of shareholding of the largest to second largest shareholder of 37.48, which is much higher than the 13.42 in private companies. The shareholder of state-owned shares is thus the largest

[27] Shanghai Stock Exchange, *China Corporate Governance Report 2009: Market for Corporate Control and Corporate Governance* (Fu Dan University Press, 2009) (in Chinese), at 28.

shareholder in the state-held listed company.

Table 1.2 Comparison of the Average Shareholdings of Controlling Shareholders (of the 831 public listed companies on the Shanghai Stock Exchange as at 31 December 2005)[28]

	State-held Listed Company	Private Listed Company
Shareholding of largest controlling shareholder	45.13%	32.64%
Ratio of shareholding of largest to second largest controlling shareholder	37.48	13.42

(C) Ownership and control

In a survey of East Asian corporations conducted by Claessens, Djankov and Lang, ownership and control are respectively measured by cash flow rights and voting rights. The ratio of cash flow rights to voting rights is measured by the degree of separation, where the smaller the ratio, the greater the separation.[29] Based on this method, a survey of public listed companies on the Shanghai Stock Exchange was conducted and published in the China Corporate Governance report 2006.[30] (See Table 1.3)

Table 1.3 Comparison of Ownership and Control

	State-held Listed Company (Shanghai)	Private Listed Company (Shanghai)
Ownership (average cash flow rights)	42.84	22.42
Control (average	45.99	34.32

[28] *Ibid.* Table 3.2.
[29] See Claessens, Stijn, Djankov, Simeon & Lang H.P., "The Separation of Ownership and Control in East Asian Corporations" (2000) 58 Journal of Financial Economics 81.
[30] *Supra* Note 18, Table 3.3.

controlling rights)		
Average ratio of cash flow rights to controlling rights	0.92	0.63

According to Table 1.3, the average ratio of cash flow rights to controlling rights in state-held listed companies is 0.92. This is higher than that in private listed companies, indicating less separation of ownership from control.

1.2 Research perspective of this thesis

1.2.1 Research questions and arguments

In the last few years, much academic research and empirical studies have examined the topic of corporate governance in Chinese corporations.[31] This thesis

[31] Tam (2002) explores the ethic issues emerging in the context of China's economic and corporate governance development. These issues include: corruption, stock manipulation, fraudulent dealing, plundering of state assets, etc. See generally On Kit Tam, "Ethical Issues in the Evolution of Corporate Governance in China" (2002) 37 Journal of Business Ethics 303. Wei (2005) explains the two main functions of Chinese securities market: corporate finance and external mechanism of corporate governance. It is further suggested to design a securities regime, combining the strengths of market-based and bank-based approach. See generally Wei Yuwa, "The Development of the Securities Market and Regulation in China" (2005) 27 Loyola Los Angeles International and Comparative Law Review 479. Wei (2006) analyzes the interaction between corporate governance and market volatility. It assesses the impact of corporate governance on the volatility of China's securities market, and concludes that developing securities market in China has helped encourage and promote sound corporate governance practices, although the monitoring functions are still weak. See further Wei Yuwa, "Volatility of China's Securities Markets and Corporate Governance" (2006) 29 Suffolk Transitional Law Review 207. Chang (2005) examines the evolving foreign participation in China's securities market, which was once forbidden but is now desired. It discusses the legal risks of investing in China, bringing up issues of weaknesses in corporate governance, private securities regulation, and judicial enforcement. See generally Chang, Terry E., "The Gold Rush in the East: Recent Developments in Foreign Participation within China's Securities Markets as Compared to the Taiwanese Model" (2005) 44 Columbia Journal of Transitional Law 279.

explores the corporate governance model in state-held listed companies in China. The following research questions are addressed:

(1) What is the current corporate governance model of state-held listed companies in China (discussed in Chapters II, III, IV and V)?

(2) Are state-held listed companies well governed under the current corporate governance model (elaborated in Chapters IV, V and VI)?

(3) If the answer to the second research question is negative, then is there any other model under which state-held listed companies may be well governed (to be proposed in Chapter VI)?

The "state-controlled" model that directs the corporate governance of state-held listed companies in China has common elements with the bank-based model, under which banks play a predominant role in corporate financing in a weak securities market. It also contains the employee participation element of the stakeholder model, but the trade unions in China are still strictly controlled by the government (see Chapter II).

The state-controlled model relates to the issue of how the state assets of China were and are managed, which is at the very "intersection" of political control and economic reform (Chapter III). It is the state-controlled model that has led to China's unique earmarks of two-tier share market and two-tier board structure, which will be discussed in Chapters IV and V, respectively.

This thesis argues that state-held listed companies in China are not well-governed under the state-controlled model, because it fails to protect minority shareholders and the two-tier board structure does not perform efficiently (Chapter IV and V) due to poor law enforcement arising from corruption in China. This thesis does not aim to make the case for a wholesale change of legal regime to establish a brand

new corporate governance system. Instead, it explores effective refinements that could improve corporate governance in Chinese listed companies through a law-controlled model and the implementation of the rule of law in China. It also addresses how, in the event that such refinements cannot be made, the practical problems arising from the "state-controlled model" can be overcome by virtue of (i) reforming the laws; and (ii) enforcing the laws. To smoothly drive the governance of state-held listed companies, a "law-controlled" model, that aims to advance the rule of law (or at least a "thin" rule of law developed from "rule by law"), enforces good corporate governance, and reduces governmental bureaucracy and political forces in business activities associated with corruption (Chapter VI).

1.2.2 Research scope

A. Public listed companies and state-held listed companies

Public listed companies are recognized by the Chinese central government as significant sources of investment in the capital market.[32] It is thus a crucial task in the reformation of the capital market to enhance the quality of public listed companies, which should focus on maximizing the benefits of shareholders as a whole.[33]

This thesis focuses on "state-held listed companies" rather than all public listed companies in China. Private listed companies are not the subject of the corporate governance model discussed here. However, private listed companies are inevitably involved in China's SOEs reform and privatization.

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[32] The Growth Enterprise Board is to be launched under the regulation of *Provisional Measures of Publicly Issuing New Shares for the First Time and Listing on the Growth Enterprise Board* (issued by the CSRC with effect from 1 May, 2009). As opposed to the Main Board, the Growth Enterprise Board is aimed to provide a securities trading market for those small or medium size enterprises.

[33] *Notice of Enhancing the Quality of Listed Companies 2005*, issued by the CSRC, with effect from 2 November, 2005.

B. “Control”

The meaning of “control” in terms of the “state-controlled model” and “law-controlled model” refers to substantial direction and discretion over a company. In terms of the definition of “controlling shareholder”, the controlling status of shareholders is based on quantity calculations, and has a “static” sense in this thesis in that the voting rights of the controlling shareholder are assumed not to vary due to daily transactions in the securities market or other activities such as rights issue or placement. Takeover regulations and the role of the market in corporate control are not approached in this thesis.

1.3 Value of this research

1.3.1 Historical background

This thesis must be placed against the background of economic and social development in China, which is currently in transition from a centrally planned economy to a market-oriented economy. This involves the modernization of the financial system, the capital market, and the management of State-owned assets. While China struggles to qualify for market economy status in the WTO, it is also undergoing privatization in which capital flows from either overseas investors or domestic private investors.

Corporate governance in China is subject to newly revised *PRC Company Law* and *Securities Law* that were promulgated in 2006, coupled with the ongoing reform of the sales of non-tradable shares of public listed companies since 2005. The

shareholding structures of Chinese public listed companies are also experiencing a transition from a traditional concentrated structure to a possibly more flexible structure. This thesis aims to explain the necessity and feasibility of improving corporate governance in state-held listed companies under China's unique political regime, economic structure, historical development, legal system, and cultural background to promote business efficiency and ensure social justice.

1.3.2 Research methodology

This research is carried out using a combination of methodologies to give a comprehensive but not abstract exploration of the topic.

Historical analysis is used to explore the development of shareholding structure in four stages: 1957-1978, 1978-1992, 1992-2005, and 2005 to the present. The unique characteristics of State-owned enterprise (SOE) reform in China are examined in Chapter III, and the Reform of Sales of Non-Tradable Shares of Public Listed Companies since 2005 are discussed in Chapter IV. Historical analysis is used again in Chapter VI to analyze the development of the rule of law and law reform in Chinese history.

Comparative research between jurisdictions is adopted in Chapter V to study the historical development of independent directors in the United States and China, and of supervisory boards in Germany and China. Specifically, independent directors in China, Singapore, the United Kingdom and the United States are explored in terms of definition of independent directors and compositions of board and board committees;

and supervisors, supervisory board, and the co-determination system in China and Germany are compared. In the last section of Chapter V, independent directors are distinguished from supervisors in relation to their functions and rights, and the proposed new division of authority between independent directors and the audit committee of the board is examined. Chapter VI focuses on an analysis of the legal framework, objectives, and administration of the Temasek Holding of Singapore in relation to the state assets that it holds in contrast to those of the state-asset holding companies in China.

Chapter V presents a case study of the Zhengzhou Baiwen Company Limited ("ZBW"), which is a former state-held listed company on the Shanghai Stock Exchange that was sanctioned by the CSRC for false disclosures in its listing documents and annual reports in 2001. The case is discussed in relation to the independence of independent directors in fulfilling their duties.

1.3.3 Feasible recommendations

From the beginning of this century, the world has faced a series of major corporate scandals, and corporate governance reform has attracted increasing global attention as a result. This thesis discusses and analyses corporate governance in state-held listed companies in China with a focus on the two-tier shareholding and two-tier board structure.

As one of society's backbones, the law cannot grow without a social bedrock. Corporate laws, securities laws, and any other relevant laws are an amalgamation of all

elements of society in the process of respecting, protecting and delivering fundamental business rights in modern society.

This research paper goes to the root of the problem in China: the corporate governance of state-held listed companies is not well governed under the state-controlled model because it is not able to address a number of thorny practical issues that apply to the governance structure, and specifically to the shareholding and board structure. These practical issues cannot be settled due to corruption, which occurs when the behavior of the state and business entities cannot be controlled by law because laws in place are not enforced. Corruption results in the non-enforcement of corporate governance, which in turn reinforces corruption. The rule of law is recognized as an effective approach to prevent state-held listed companies from falling into a mire of corruption and dictatorship, but in China the rule of law may not take effect because of the political obstacle of the one-party dictatorship of Communist Party of China (CPC).

1.4 Organization and framework of this thesis

This thesis is divided into three parts and seven chapters (see Figure 1.1).

Chapters I, II, and III constitute the first part, which gives an overview of corporate governance in public listed companies in China. Chapter I addresses the research questions, arguments and research scope, followed by an explanation of the methodology and value of this research. Chapter II explores the state-controlled model by analyzing its common elements with the bank-based model and stakeholder model respectively, all of which are connected with the management of China's state

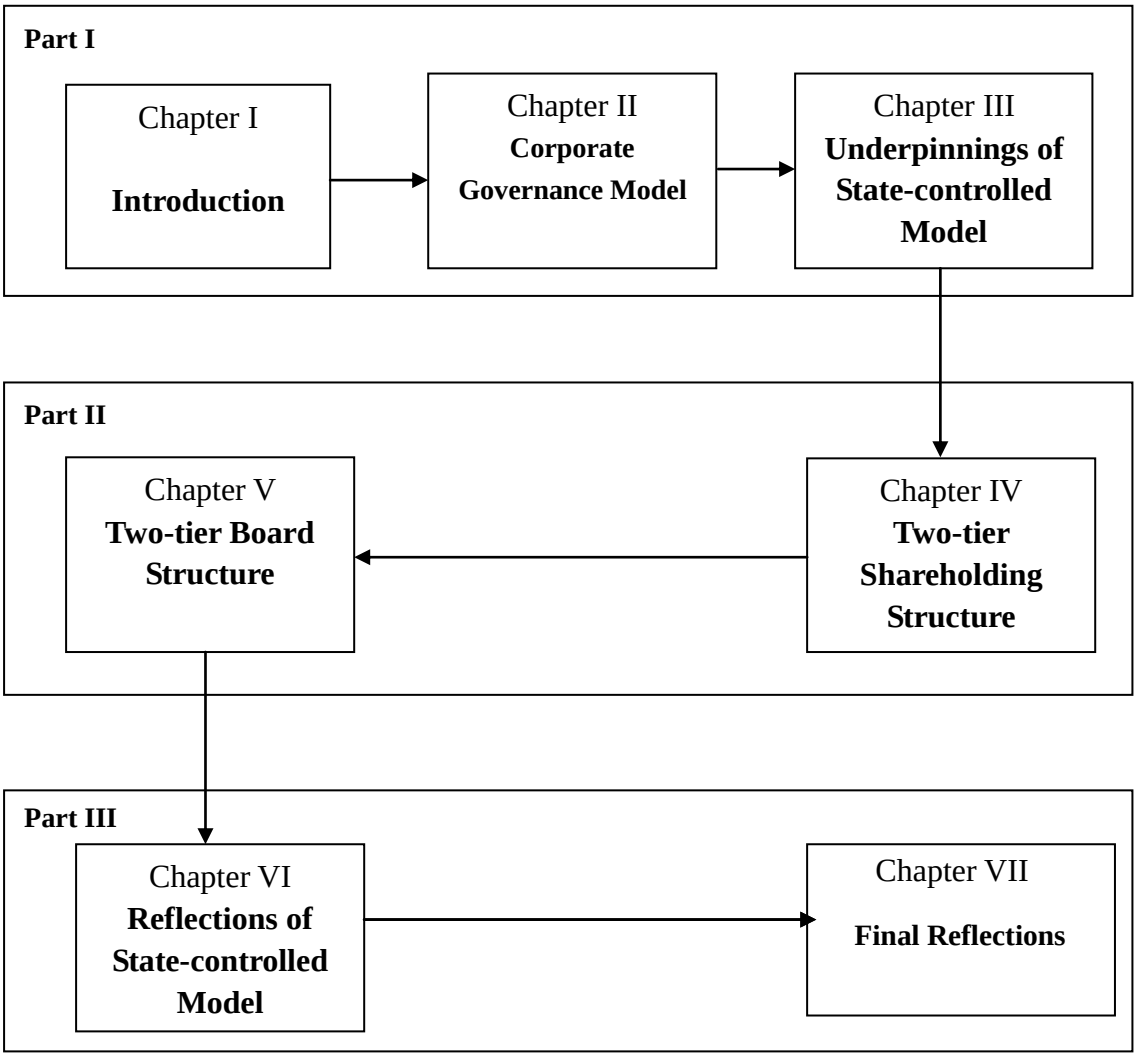
assets during its economic transition from a state-planned to a market-oriented economy through SOE reform. Chapter III investigates the underpinnings of the state-controlled model, which hinges upon and lies at the intersection of political control and economic reform, and looks at how well managed multi-level state assets are in China.

The second part consists of Chapter IV and V., which explore the hallmarks of the model, that is, two-tier shareholding and a two-tier board in state-held listed companies. Chapter IV discusses the two-tier shareholding structure and the Reform of Sales of Non-Tradable Shares of Public listed Companies. Chapter V comprehensively explores the characteristics of two-tier boards by comparing independent directors in terms of definition, board composition, and board-committee composition in China, Singapore, the United Kingdom, and the United States. It also distinguishes the supervisory board system in China and Germany, and explores the qualification, nomination, election, rights, and duties of independent directors and supervisors. In Chapters IV and V, the issue of whether state-held listed companies are well governed under the state-controlled model is addressed by exploring a number of practical issues arising from state-controlled ownership under the two-tier shareholding and two-tier board structure.

Finally, the third part is composed of Chapter VI and VII. Chapter VI highlights that whether state-held listed companies in China are well governed under the state-controlled model depends on whether certain practical issues can be resolved under the current state-controlled model, and further examines the causes and

rationality of the failure of the model to work effectively. It is then proposed that corporate governance in state-controlled listed companies could be improved under a law-controlled model based on the progressive pursuit of the rule of law, or at the very least by the reform and enforcement of current laws. The five practical issues posed by Chapter IV and V are then resolved through such a process of law reform and enforcement. The Chapter VII gives some final reflections on the challenges and trends of corporate governance in Chinese state-held listed companies.

Figure 1.1 Organization and Framework of this Thesis



Chapter II Corporate Governance Model

"Let us not look back in anger, nor forward in fear, but around in awareness."

James Thurber, American Writer (1894-1961)

The corporate governance of China's state-held listed companies is a mixed model with a variety of elements from the bank-based model (e.g., a creditor-oriented emphasis) and the stakeholder model (e.g., weak trade union rights and employee participation), and with its hallmarks of a two-tier share market and a two-tier board structure. In this thesis, this mixed model is termed the "state-controlled model". Under the state-controlled model, governments exercise their control over the corporate affairs of state-held listed companies with "substantial discretion".[34] The state-controlled model is currently undergoing both political control and economic reform. This Chapter explores the state-controlled model's elements that it as in common with the bank-based model and stakeholder model in the Chinese context.

2.1 Market-based model versus bank-based model

2.1.1. Overview

The "bank-based model" is characterized by "weak securities markets, high private benefits of control, and low disclosure and market transparency standards, with only a modest role played by the market for corporate control, but with a

[34] Henry Hansmann & Reinier Kraakman "The End of History for Corporate Law" (2001) 89 Geo.L.J. 439, at 447.

possibly substitutionary monitoring role played by large banks."[35] Under this model, the influence of banks is exerted through several roles, including those of "important suppliers of external finance, [and] holders of firm equity and seats on the firm's management board." [36] The banks and financial institutions usually play a predominant and central role in corporate monitoring.[37] The advantage of this model is that given a bank's "special position in the economy, the better information it has regarding corporations and the financial system, and the more efficient [its] monitoring and lending function."[38]

In contrast to the bank-based model, the market-based model tends to rely on market activity such as takeovers to secure corporate control. In typical public listed companies with a dispersed ownership structure, a large number of investors have little incentive to be involved in monitoring or to control the corporation.[39] In this case, the stock markets have four essential functions: (1) information aggregation on

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[35] See Yuwa Wei, *Securities Market and Corporate Governance* (Ashgate Publishing, Ltd., 2009), at 81; See also Mayer Colin, "Stock Markets, Financial Institutions, and Corporate Performance", in *Capital Markets and Corporate Governance* (edited by N. Dimsdale & M. Prevezer) (Oxford: Clarendon Press, 1994) 179-94.See for reference Coffee, John C., "The Rise of Dispersed Ownership: The Role of Law in the Separation of Ownership and Control" (December 2000), Columbia Law and Economics Working Paper No. 182. Available at SSRN: http://ssrn.com/abstract=254097 or doi:10.2139/ssrn.254097.

[36] James Laurenceson & Joseph C.H. Chai, *Financial reform and economic development in China* (Cheltenham, UK; Northhampton, MA: Edward Elgar, 2003), at 88-9.

[37] Barbara Cooper, *The ICSA Handbook of Good Boardroom Practice (2nd ed.)* (ICSA Publishing, 2006). It affirms that there are other controlling shareholders inside those model-based companies: family control, governments, or other corporations. See *Barbara Cooper*, at 32.

[38] On Kit Tam, *The Development of Corporate Governance in China* (Northampton, Ma: Edward Elgar Publishing 1999), at 33-4.

[39] See Mayer Colin, "Stock Markets, Financial Institutions, and Corporate Performance", in *Capital Markets and Corporate Governance* (edited by N. Dimsdale & M. Prevezer) (Oxford: Clarendon Press, 1994), at 188.

which to establish share prices that can help to monitor firms; (2) financing, or providing risk capital for investment; (3) diversification and hedging; and (4) corporate control, whereby managerial failure is corrected through the market mechanism.[40] Roe (1993) suggests that shareholder diversification in an active stock market is the "classic economic model of the public firm."[41]

However, markets suffer from two drawbacks. The first is the separation of ownership and control, and the second is that the interests of stakeholders other than shareholders are not fully reflected.[42] Tan *et al.* (2006) further generalize three inherent flaws in practice. First, directors may not have the expertise to fulfill their duties to shareholders; second, the external competitive market may not protect shareholders from incompetent management; and third, the securities market may not necessarily reflect the long-term value of a company.[43] Similarly, the bank-based model, under which the problems of proxy fights or hostile takeovers seldom arise, suffers from weaknesses in practice, such as conflicts of interest due to banks serving more than one supervisory board and supervisory boards have a weak monitoring position as creditors and failing to pursue the interests of shareholders.[44]

In China, the bank-based model is based upon the financing functions of banks as creditors, as their monitoring functions have shrunk to some extent because banks in China are forbidden to invest in listed companies. Hence, they monitor companies

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[40] *Ibid.* at 179.
[41] Mark J. Roe, "Some Differences in Corporate Structure in Germany, Japan, and the United States" (1993) 102 Yale L.J. 1927, at 1928.
[42] *Supra* Note 39, at 191.
[43] Tan Lay Hong, Tan Chong Huat & Long Hsueh Ching, *Corporate Governance of Listed Companies in Singapore* (Singapore: Sweet & Maxwell Asia, 2006).
[44] *Ibid.* at 14.

by exercising the rights of creditors, rather than those of shareholders.

2.1.2 China

A. Financing functions

Tam (2002) compares the main characteristics of the market-based and bank-based models. Using the same variables to explore state-held listed companies in China reveals that China's current model is similar to the bank-based model with regard to financing (see Table 2.1).

Table 2.1 Comparative Characteristics of Corporate Governance Models[45]

Characteristics	**Market-based Model**	**Bank-based Model**	**China Model**
Control	Investors usually free riders except for some active institutional investors	Banks and other financial institutions	Controlling shareholder
Financing[46]	Reliance on securities market	Reliance on bank credit	Reliance on bank credit
Transactions	Arms-length	More network and	Rampant

[45] The structure and conclusion of this table are based on the comparative table in On Kit Tam, "Ethical Issues in the Evolution of Corporate Governance in China" (2002) 37 Journal of Business Ethics 303, at 309. I further add into the table more information on China's part for supplementation.

[46] See Erik Berglöf, "Capital Structure as a Mechanism of Control: A Comparison of Financial Systems, in *The Firm as a Nexus of Treaties* (edited by Masahiko Aoki, Bo Gustafsson & Oliver E. Williamson), at 237-62 (London: Sage, 1990). Berglöf defines financial system as "institutional arrangements designed to transform savings into investments and to allocate funds among alternative uses within the industrial sector". He summaries three characteristics of market-oriented system, distinguished from market-oriented system: first, banks "hold a higher share of total domestic financial assets; second, lending activity of banks is "more directed to corporate financing"; third, there are "heavy concentration and substantial government ownership". Furthermore, costs of delegation from shareholders to managers shall be compared with the gains from risk spreading.

	transactions	alliance dealings	related-party transactions by controlling shareholders and managers

In China, banks are the main sources of external financing as creditors of corporations. According to recent statistics from the *China Corporate Governance Report 2007*,[47] more than 70 percent of the debts of all Chinese enterprises are owed to commercial banks. The first annual report of the China Banking Regulatory Commission (CBRC, established in 2003 to regulate the entire banking system in China) issued in 2006 indicates that the total loans of the Chinese banking institutions rose from RMB 16977.1 billion in 2003 to 23828.0 billion in 2006,[48] a 40.4% increase.

B. Monitoring function

Banks, as creditors, not only provide most of the financial resources, but also serve to monitor corporate business. Under the bank-based model, the monitoring authority of the banks is exercised through the possession of voting power by direct stock ownership and control over investment companies or the stock deposited by stock owners through brokerages.[49] Banks may display different behavior in different

[47] Shanghai Stock Exchange, *China Corporate Governance Report 2007: Stakeholders and Corporate Social Responsibility* (Fu Dan University Press, 2007) (in Chinese), at 66.

[48] The statistics are from the CBRC Annual Report 2006, at 135. Available at the CBRC website: http://www.cbrc.gov.cn

[49] *Supra* Note 41, at 1938-48.

positions. When a bank is a creditor, it tends to choose more conservative strategies of business to avoid risk, whereas when it is a shareholder, it has more incentive to run risks to obtain higher profits. When it is both creditor and shareholder, it will try to balance the capital structure with business risk.[50]

The German universal bank system is famed for the dual role of its banks as both creditors and shareholders or quasi-shareholders (through proxy systems), in which the banks are facilitated to participate in corporate governance by exercising a controlling power over supervisory boards.[51] In the typical Japanese main bank system, banks are involved in the private sector though their ownership of company stocks.[52] The difference between Germany and Japan is that in the former the bank is usually represented on the supervisory board that oversees the company, whereas in the latter the banks do not tightly control the management or intervene inside the company unless the company is performing poorly and bad results are forecasted.[53]

The bank-based model in China is distinct from that in Germany and Japan, as it is prohibited under the *Commercial Bank Law* for the commercial banks in China to undertake trust and investment business and securities dealing, and to invest in

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[50] *Supra* Note 46.

[51] Jean J. du Plessis, *German Corporate Governance in International and European Context* **(**Berlin; New York: Springer, 2007), at 212-3.

[52] It is stated that "[D]ifferent systems are suited to different circumstances. Germany and Japan benefited from bank-based governance in their post-war reconstruction phases, but are now moving towards a more market-oriented one". See Becky Chiu & Mervyn K. Lewis, *Reforming China's State-owned enterprises and banks* **(**Cheltenham, UK; Northampton, MA: Edward Elgar Pub., 2006), at 75.

[53] Ronald J. Gilson, "Lifetime Employment: Labor Peace and the Evolution of Japanese Corporate Governance" (1999) 99 Colum.L.Rev. 508, at 529-30.

enterprises.[54] Commercial banks are not qualified to be shareholders by law, and are thus unable to play an active role in corporate governance, being confined instead to a more outside role as creditors.

C. China's banking reform and treatment of non-performing loans (NPLs)

(A) Before reform (late 1970s to mid-1990s)

The development of the banking sector had a crucial impact on the growth of business enterprises, and especially SOEs, before the banking reform. Under the state-planned economic system, the banks were parts of the government mechanism, and were essentially passive providers of funds under the direction of the government. The banks in China have long been closely connected with SOEs, and have granted loans as a form of resource allocation under government guidance.[55]

The "big four" state-owned commercial banks – the Bank of China (BOC), Construction Bank of China (CBOC), Bank of Agriculture of China (BOAC), and Industrial and Commercial Bank of China (ICBC) – were established between the late 1970s and the early 1980s. The "big four" have particular financing roles under government policy in the areas of foreign exchange, construction, agriculture, and industry and commerce, respectively. In a sense then, they are policy banks rather than commercial banks.

Since 1983, the amount of direct bank loans with no interest granted to SOEs has

[54] *Supra* Note 6, Sec.43.

[55] See William A. Byrd, "Entrepreneurship, Capital, and Ownership", in William A. Byrd & Qingsong Lin (edited), *China's Rural Industry: Structure, Development, and Reform* (Oxford, 1990)199-205, at 214-5.

substantially reduced, and instead the banks have begun to increase the number of interest-bearing loans to SOEs.[56] In an empirical study, Cull and Xu find a positive link between bank finance and SOE profitability in China in the 1980s, with a weaker link in the 1990s.[57] The SOEs monopolized the market during the state-planned economy period when demand exceeded supply. However, as Karacadag recognizes, banks still "have little incentive to exert market discipline over borrowers, particularly the large SOEs," as governments make "implicit guarantees" for loans.[58]

(B) Post-reform (since the mid-1990s)

A more systematic reform of banking was not initiated until the mid-1990s,[59] with the promulgation in 1995 of the *Law of People's Bank of China*[60] and the *Commercial Bank Law*.[61] Banking reform was not carried out at the same time as the economic reform in 1978,[62] but was instead launched based on the market economy system after the reform of corporatization in the early 1990s. In 1994, three policy banks were set up: the National Development Bank, Import and Export Bank, and

[56] John Hassard *et al*., *China's State Enterprise Reform: From Marx to the Market* (New York, NY: Routledge, 2007), at 67.
[57] See Cull, Robert & Lixin Colin Xu, "Who Gets Credit? The Behavior of Bureaucrats and State Banks in Allocating Credit to Chinese State-owned Enterprises" (2003) 71 Journal of Development Economics 533; See also Cull, Robert, and Lixin Colin Xu, "Bureaucrats, State Banks, and the Efficiency of Credit Allocation: The Experience of Chinese State-owned Enterprises" (2000) 28 Journal of Comparative Economics 1.
[58] Cem Karacadag, "Financial System Soundness and Reform" in *China: Competing in the Global Economy* (edited by Wanda Tseng and Marcus Rodlauer) (Washington: IMF, 2003).
[59] See Weitseng Chen, "WTO: Time's UP for Chinese Banks – China's Banking Reform and Non-performing Loan Disposal" (2006) 7 Chi.J.Int'l L 239.
[60] It comes into force on 18 March 1995 and is revised in December 2003.
[61] *Supra* Note 6.
[62] See for example *supra* Note 59.

Agriculture Development Bank. The three banks took over the "policy" functions of the "big four," which from then on began to act as real commercial banks. The current banking system in China, under the supervision of the CBRC, is composed of various levels of institutions. The People's Bank of China is the central bank; the principal parts of the system are the commercial banks, including the "big four" state-owned commercial banks and other joint-stock banks; the institutions are the policy banks, cooperative banks, rural credit cooperatives, and financial asset management companies.[63]

In reality, the central government and the local governments still interfere with the capital market by directing bank loans,[64] and bank lending is often biased in favor of SOEs.[65] The banks may give loans to SOEs without taking account of the profitability of the enterprises,[66] because the SOEs are the concern of governments, which have substantial regional economic and social influence.[67]

(C) Non-performing loans (NPLs)

Bank loans are graded into five categories based on the evaluation of their inherent risk, an approach similar to that used by the US banking regulators.[68] The

[63] *Ibid.* at 130.
[64] Genevieve Boyreau-Debray & Shang-Jin Wei, "Pitfalls of a State-Dominated Financial System: The Case of China" Working Paper No. 11214 (Cambridge, Massachusetts: National Bureau of Economic Research) 2005, at 2.
[65] See Wei Shang-Jin and Tao Wang, "The Siamese Twins: Do State-owned Banks Favor State-owned Enterprises in China?" (1997) 8 China Economic Review 19.
[66] See Richard Podpiera, "Progress in China's Banking Sector Reform: Has Bank Behavior Changed", IMF Working Paper WP/06/71 2006.
[67] *Supra* Note 64, at 18-9.
[68] *Notice on the Issuing Guidance on Risk-based Loan Classification*, issued by the People's Bank of China, with effect from January 2002.

five grades are pass, special mention, substandard, doubtful, and loss. The last three grades are rated as non-performing loans (NPLs). Most NPLs in China are not secured loans but rather consumptive loans that are granted to SOEs by government policy or internal banking corruption.[69]

There are three main approaches to deal with NPLs: write-offs and sale by asset; recapitalization; and inspection by the CBRC.

a. NPLs write-offs and sales

Four AMCs (China Cinda, China Great Wall, China Orient, and China Huarong) were set up in 1999 specifically to dispose of the NPLs of the "big four" state-owned commercial banks. Their main technique of disposing of NPLs is asset securitization. The process comprises three stages: first buying bad assets from the banks, which receive cash to write off the NPLs, then packaging those assets by securitization, and finally selling them in a secondary market at a higher price for returns.

b. Re-capitalization

At the end of 2004, the BOC and CBOC were respectively recapitalized with 22.5 billion US dollars from foreign exchange reserves. Hui Jin Holdings Company (Hui Jin) was set up for this purpose, the shareholders of which are the Ministry of Finance, People's Bank of China, and National Foreign Exchange Bureau. Hui Jin is the majority shareholder (85%) of the BOC and CBOC, on behalf of Chinese

[69] *Supra* Note 59, at 254.

government.

In April 2005, the ICBC was recapitalized by Hui Jin with 15 billion US dollars. Later, in November 2008, it recapitalized the BOAC with RMB 130 billion. Hui Jin holds 50% of shareholdings of both ICBC and BOAC following re-capitalization.

c. CBRC

The CBRC has set up a tripartite coordination mechanism with two financial supervisory committees, the CSRC and China Insurance Regulatory Commission (CIRC) of the central government. The coordination mechanism works through "co-supervisory meetings" and a "continuous contact mechanism," which is a channel for communication between the three Commissions to discuss specific issues.[70]

The CBRC has adopted many measures to deal with NPL problems. For example, all commercial banks are required to have an internal control system to regularly evaluate the financial status of their clients.[71] The CBRC collates client risk statistics and set up an early warning system in July 2004 that requires the major commercial banks to submit a monthly report.[72] Furthermore, the CBRC assists the banks to improve their management of credit risk and due diligence.[73] Moreover, the CBRC carries out on-site examinations of banking institutions, covering 35 percent of all banks every year.[74]

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[70] *Supra* Note 48, at 84.
[71] *Ibid.* at 75.
[72] *Ibid.* at 74.
[73] *Ibid.* at 75.
[74] *Ibid.* at 80.

The NPL ratios have declined due to write-offs and recapitalization. Furthermore, the banks have improved their lending decisions under the oversight of the CBRC. The most significant change for the "big four" under the reform of the banking sector is that they have been transformed from wholly state-owned banks into joint-stock companies. In addition to the shareholding of Hui Jin on behalf of the state, the general public and foreign strategic investors such as the Bank of America and Temasek have minority shareholdings in the bank.[75] Diminishing the amount of NPLs is the first step in the process of banking reform,[76] but the banks are also improving their own internal control and risk management measures to better serve their role as creditors to enterprises.

D. Legal protection of creditors under the *Company Law* and *Bankruptcy Law*

(A) Going concerns

The capital maintenance rule applies when the company is a going concern, and prohibits the issuing of shares under par value or capital reduction except in certain legitimate circumstances. When fundamental corporate changes are going to take place, creditors must be notified by the company and may, within a reasonable period after the receipt of the notice, demand the company to clear its debts or to provide corresponding guaranties.[77]

(B) Liquidation

[75] See Richard Podpiera, "Progress in China's Banking Sector Reform: Has Bank Behavior Changed", IMF Working Paper WP/06/71 2006, , at 6.
[76] This is from the Speech of Mr. Li Ruogu, Vice President of People's Bank of China, at the International Finance Forum in October 2003.
[77] *Supra* Note 4, Sec.104.

When any company is dissolved, a liquidation group must be formed within fifteen days of the occurrence of the cause of dissolution. The liquidation group of a public listed company is composed of the directors or any other persons determined at a shareholder meeting. The main functions of a liquidation group include evaluating the properties of the company, producing balance sheets and asset checklists, notifying creditors, handling the ongoing business of the company, paying off the outstanding taxes, and participating on behalf of the company in legal litigation and proceedings.[78]

There are several common protection arrangements for creditors during liquidation. For example, under the priority rule of corporate law, creditors have the privilege to claim corporate assets before shareholders. Creditors also have the right to appeal to the court to designate outside lawyers and accountants to form a liquidation group if no liquidation group has been formed within the time limit of fifteen days.[79]

The first *Bankruptcy Law* (annulled) in China was promulgated in 1986.[80] The law only applied to SOEs, whose right to file for bankruptcy was restricted. Public utility enterprises or other enterprises with a crucial impact on the national economy and people's livelihood under the subsidization of the government, were not allowed to declare bankruptcy.[81]

In contrast, the *Enterprise Bankruptcy Law* (2006) confers freedom to all Chinese enterprises to initiate bankruptcy procedures, and offers some protection to creditors. It provides that the bankruptcy administrator has the right to plead to the

[78] *Ibid*. Sec.184 and185.
[79] *Ibid*. Sec.184.
[80] The *Law of the People's Republic of China on Enterprise Bankruptcy (For Trial Implementatio)*, promulgated on December 2, 1986.
[81] *Ibid.* Sec.3.

court for revocation of: (1) transactions in which corporate assets are transferred to a third party free of charge or at an obviously unreasonable price; (2) debt guaranteed by the company that has other sources of guarantee. The transactions and guarantees must have taken take place within the year before the People's Court accepted an application for bankruptcy.[82] Transactions involving concealed or falsified corporate assets are rendered invalid.[83]

(C) Lifting the corporate veil

Limited liability has been a fundamental tenet of company law since the late nineteenth century and the case of *Salomon v. A Salomon and Co. Ltd*[84] that ruled that a company is a separate legal entity from its shareholders. Davies (2003) generalized two advantages to justify this tenet. First, it facilitates public investment, about which ordinary members of society have no professional knowledge, and second, it promotes the stable operation of a public securities market.[85]

However, the possibility of the corporate abuse of this principle exists, because in practice the assets of shareholders are not completely separate from those of the company. Legal intervention by either statutory regulation or judicial decision will occur when creditors are not able to effectively protect themselves through existing contractual arrangements.[86]The underlying justification for the lifting of the corporate veil in common law is that the company in question, as a business form, has been used

[82] *Supra* Note 9, Sec.31.
[83] *Ibid.* Sec.33.
[84] [1897] AC 22.
[85] Davies, Paul Lyndon, *Gower and Davies' Principles of Modern Company Law* (London: Sweet & Maxwell, 2003), at 176-7.
[86] Reinier Krakkman *et al.*, *The Anatomy of Corporate Law: A Comparative and Functional Approach* **(**Oxford University Press, 2004), at 72.

for device or manipulation, for example as an agent for the company's controllers,[87] as a façade or sham,[88] for fraud,[89] or to evade legal obligations.[90] However, this remedy is supported by the court only in exceptional circumstances and after close consideration.

Before the *Company Law* was revised in 2006, the Supreme Court made it clear in the *Reply of the Supreme Court to the Superior Court of Guangdong Province* in 1994[91] that any company set up by an enterprise is a separate legal entity from the enterprise, and assumes legal liability by itself. If the company is not capitalized or is insufficiently capitalized by the enterprise, then it is not regarded as a separate entity, and its liability is assumed by the enterprise.

"Lifting the corporate veil" was first brought in with the revision of the *PRC Company Law* in 2005. The revised law prescribes that where any shareholder of a company has severely abused the company as being a separate legal entity, and has injured the interests of any creditor, then the shareholder(s) shall be jointly liable for the debts along with the company.[92]

However, this provision is too simple to be applied in practice,[93] given China's status as a civil law country that does not officially recognize case law as a binding force in the civil law system. For example, it does not address whether the scope of

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[87] *Smith, Stone & Knight v. Birmingham Corporation* [1939] 4 All ER 116.
[88] *TV Media Pte. Ltd. v. De Cruz Andrea Heidi* [2004] 3 SLR 543.
[89] *Re A Company* [1985] BCLC 333.
[90] *Gilford Motor Co. v. Horne* [1933] Ch. 935 (C.A.); *Jones v. Lipman* [1962] 1 W.L.R. 832.
[91] "*The Reply Regarding the Burden of Liability of the Revocation or Going out of Business of a Company Set Up by an Enterprise*", March 30, 1994. In China, the Supreme Court issues the replies to the questions of lower courts to address specific legal issues. The replies by the Supreme Court have legal force and effect in China.
[92] *Supra* Note 4, Sec.20.
[93] Before the *Company Law* was revised in 2005, there were cases with similar fact matrix; that is, the company is not a separate entity, and the courts would apply the civil law principles of honesty and fairness for judgment.

"creditors" should include parties to which a company is indebted due to tort or unjust enrichment,[94] whether "shareholders" should cover all shareholders, including minority shareholders, the extent of the creditor's burden of proof, and whether the creditor(s) in question should assume the whole burden?

2.2 Stakeholder model

2.2.1 Theoretical framework

Freeman (1984) presents a broad definition of stakeholder in terms of business planning: "[T]hose groups without whose support the organization would cease to exist"[95] and "who can affect or are affected by the achievement of the organization's objectives."[96] Dean (2001) suggests that those who "participate in or are affected by the company, as individuals and groups, all merit consideration and involvement in its decision-making . . . have a stake in it."[97] Dean divides stakeholders into "primary" and "secondary" groups. Primary stakeholders are those who "count on a 'strict business' basis for day-to-day participation, consisting of shareholders, managers, customers, employees, creditors, suppliers." Secondary stakeholders "have influence and effect in specific, important situations of concern to them," such as "the national and local media, the community and the environment."[98]

Hemraj (2005) proposes that the stakeholder theory rests on the director's responsibility to consider stakeholders' interests and to balance the competing interests of stakeholders. However, the theory does not suggest that the company

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[94] Liu Junhai, *Institutional Innovations of New Corporate Law: Legislative and Judicial Controversies* (Law Press China, 2006) (in Chinese), at 88.
[95] Freeman, R.E., *Strategic Management: A Stakeholder Approach* (Boston: Pitman, 1984), at 31.
[96] *Ibid.* at 46.
[97] Dean, Janice, Directing Public Companies: Company Law and Stakeholder Society (London: Cavendish Publishing Ltd., 2001).
[98] *Ibid.* at 103.

should sacrifice the interests of shareholders for the benefits of other stakeholders.[99] The Hampel Report (1998) criticizes the theory:

> "The directors as a board are responsible for relations with stakeholders; but they are accountable to the shareholders. This is not simply a technical point. From a practica1 point of view, to redefine the directors' responsibilities in terms of the stakeholders would mean identifying all the various stakeholder groups; and deciding the nature and extent of the directors' responsibility to each. The result would be that the directors were not effectively accountable to anyone since there would be no clear yard stick for judging their performance."[100]

More broadly, this means that while continuing with its development and maximizing the benefits of shareholders, a listed company should assume social responsibility for the welfare, environmental protection, and public interest of the community.[101] Freeman and Evan (1997) consider the firm as a framework of a series of multiple contracts among stakeholders.[102] Corporate law, which considers the interests of social constituencies, is often criticized for only working within the range of private law, whereas it should also have meaning in the area of public law.[103] Wood and Jones (1995) integrate the stakeholder theory with the study of corporate social responsibility (CSR), and suggest that the development of CSR has gained theoretical support from the stakeholder theory.[104] The essence of social

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[99] Hemraj, Mohammed B., "Corporate Governance: Rationalising Stakeholder Doctrine in Corporate Accountability" (2005) 26 Company Lawyer 211, at 212.

[100] The UK Committee on Corporate Governance, Hampel Report, January 1998, at para.1.17.

[101] *Ibid*. Art.86.

[102] R. Edward Freeman & William M. Evan, "Corporate Governance: A Stakeholder Interpretation" (1990) 19 No.4 Journal of Behavioral Economics 337, at 354.

[103] Ken Greenfield, *The Failure Of Corporate Law: Fundamental Flaws And Progressive Possibilities* **(**University of Chicago Press, 2006), at 162.

[104] Donna J. Wood & Raymond E. Jones, "Stakeholder Mismatching: A theoretical Problem in Empirical Research on Corporate Social Performance" (1995) 3 No.3 International Journal of Organizational Analysis 229. This argument could also be found in other legal scholarship. See for example, David Monsma, "Equal Rights, Governance, and the Environment: Integrating Environmental Justice Principles in Corporate Social Responsibility (2006) 33 Ecology L.Q. 443; see also Cynthia A. Williams, "Corporations Theory and Corporate Governance Law Corporate Social

responsibility is a "concern for the ethical consequences of one's acts as they might affect the interests of others."[105]

CSR originated from the voluntary charitable contributions of business.[106] Clark (1916) was the first to make an official link between of social responsibility and business, stating that "we need an economics of responsibility, developed and embodied in our working business ethics."[107] Davis (1967) concludes from this statement that the business system does not exist by itself and that "a healthy business system cannot exist within a sick society."[108]

The *UN Global Compact*[109] on CSR contains ten principles in the areas of human rights, labor standards, the environment, and anti-corruption. The *SA 8000 Standard*[110] is an auditable certification standard for labor based on the convention of the International Labor Organization. The *OECD Guidelines for Multinational Enterprises (2000)*[111] and the *Communication on Corporate Social Responsibility*[112] issued by the European Commission set out the duty of company and directors in terms of social and environment impact. The US *Sarbanes-Oxley Act* even requires each issuer to disclose whether or not it has adopted a code of ethics for senior

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Responsibility in an Era of Economic Globalization" (2002) 35 U.C. Davis Law Review 705.

[105] Keith Davis, "Understanding the Social Responsibility Puzzle: What Does the Businessman Owe to Society?" (1967) 10 Business Horizons 45, at 46.

[106] George A. Steiner & John F. Steiner, *Business, Government, and Society: A Managerial Perspective Text and Cases* (10th ed.)（Boston, Mass.: Mcgraw-Hill, 2003, at 127; See also David Logan and Joyce O'Connor, "Corporate Social Responsibility and Corporate Citizenship: Definitions, History and Issues" in *Corporate Social Responsibility and Alcohol: The Need and Potential for Partnership* (edited by Marcus Grant and Joyce O'Connor) (New York: Routledge, 2005), at 8-9.

[107] J. Maurice Clark, "The Changing Basis of Economic Responsibility" (1916) 24 No.3 Journal of Political Economy 209, at 210.

[108] *Supra* Note 105, at 46.

[109] http://www.unglobalcompact.org

[110] http://www.sa-intl.org

[111] http://www.oecd.org

[112] http://www.corporatejustice.org

financial officers.[113] Because social responsibility may vary with company characteristics, such as corporate size, industry, culture, and location,[114] there is no uniform standard of CSR across jurisdictions, and the international, regional and domestic CSR guidelines are only minimum standards.[115]

2.2.2 Legal implications

A. Overview

The stakeholder theory is criticized for creating guidelines that are too vague to follow by law, as it is not clear "to what each stakeholder is entitled" and "how management should balance competing demands among stakeholders."[116] In addition, the stakeholder philosophy may cause directors to lose the focus of their duties.[117]

In the United Kingdom, under Sec.172 of the *Companies Act 2006*, it is the duty of directors to have regard to the interests of the company's employees; to the need to foster the company's business relationships with suppliers, customers, and others; and

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[113] *Sarbanes Oxley Act*, Sec.404. The *Sarbanes Oxley Act* of 2002 is enacted on 30 July, 2002, Sec.406.

[114] *Ibid.* at 148.

[115] Through the analysis of the existing 51 empirical results of the relationship between social performance and financial performance of corporation, Griffin & Mahon (1997) consider that there are variability and inconsistency in those results of positive relationship. Such contradictory results are caused by the conceptual or methodological differences in the definition of social and financial performance. See Jennifer J Griffin & John F Mahon, "The corporate social performance and corporate financial performance debate: twenty-five years of incomparable Research" (1997) 36 Business and Society 5. Roman, Hayibor & Agle (1999) reorganize the inaccurate categorization of the existing literature made by Griffin and Mahon with more rigorous standards and find more positive and neutral impacts of social performance on financial performance and conclude that the vast majority of studies support the positive results. See Ronald M Roman, Sefa Hayibor & Bradley R. Agle, "The Relationship between Social and Financial Performance" (1999) 38 Business and Society 109. However, the Stakeholder Index by the China Corporate Governance Research Centre of Nan Kai University finds that there is no distinct relevance between social and financial performance. See *supra* Note 47, at 130-1.

[116] *Supra* Note 106, at 17.

[117] Hans Tjio, "The Rationalization of Directors' Duties in Singapore" (2005) 17 SAcLJ 52, at 81.

to the impact of the company's operations on the community and the environment.[118] In certain circumstances, it is also their duty to consider or act in the interests of the creditors of the company.[119]

In UK common law, if a company is insolvent or close to insolvency, directors must consider the interests of creditors. In the case of *Walker v. Wimbourne (1976),* where the directors had improperly disregarded the interests of creditors, Barwick C.J. and Mason J. opined that creditors' interests might be prejudiced by the movement of funds between companies in the event of a company becoming insolvent. [120]

In the more recent case *Re Welfab Engineering (1990),*[121] where directors had accepted an offer for the purchase of the company from a buyer who guaranteed to continue the business and maintain the employees, rather than accepting a higher cash offer, the directors were held not liable for the company's insolvency, as they had acted properly in taking into employment into account.

In the USA, Section 2.01(b) of the *Principles of Corporate Governance (1992)* of the American Law Institute states that a corporation, in conducting its business, "may take into account ethical considerations that are reasonably regarded as appropriate to the conduct of business" and "may devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes."[122]

In some jurisdictions, such as the United States and Singapore, stakeholder

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[118] *Companies Act 2006 (c.46),* Sec. 172(1)(b)(c)(d). The UK *Companies Act 2006* has superseded the Companies Act 1985. The new Act came into effect on Royal Assent in November 2006, and some provisions of it began to come into force. Parts of the 1985 Act remain in force until it is repealed in the final implementation order, currently scheduled for 1 October 2009.

[119] *Ibid.* Sec. 172(3).

[120] (1976) 137 CLR 1.

[121] [1990] BCLC 833.

[122] American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* (St. Paul, Minn.: American Law Institute Publishers, 1994).

interests are implicitly recognized, and every stakeholder is protected through contract law or specific legislation to protect employees, creditors, customers, and the environment.[123]

B. China

In China, stakeholders are expressly defined by corporate law and regulations. The *PRC Company Law* sets out the fundamental framework for stakeholders as follows: "a company shall comply with not only law, but also social morality and business morality."[124] A company is also required to act in good faith, accept the supervision of the government and the general public, and to bear certain social responsibilities.

The *Code of Corporate Governance of Public Listed Companies* sets out the scope of stakeholders as "creditors, employees, consumers, suppliers, the community, etc."[125] In terms of employees, it states that feedback should be encouraged with regard to the company's operation, financial situation, and important decisions that affect employee benefits through direct communication with the board of directors, the supervisory board, and management personnel.[126] The provisions of the *PRC Company Law* and the *Code* are written in a general way. The *Code* provides that a public listed company shall "actively cooperate with its stakeholders and jointly advance the company's sustained and healthy development"[127] and shall "provide the necessary means to ensure the legal rights of stakeholders", who "have opportunities

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[123] See Marleen O'Connor, "Labor's Role in the American Corporate Governance Structure" (2000) 22 Comp. Lab. L. & Pol'y J. 97. See also Kala Anandarajah, *Corporate Governance Compliance* (2nd ed.) (Singapore: LexisNexis, 2003), at XVIII[104].

[124] *Supra* Note 4, Sec.5.

[125] *Supra* Note 10, Art. 81.

[126] *Ibid*. Art.85.

[127] *Ibid*. Art.82.

and channels for redress for infringement of rights."[128] However, how the company cooperates with its stakeholders, the "legal rights" of those stakeholders, and the "opportunities and channels" to protect their rights are not clarified by law. As a result, the catch-all provisions are too abstract to have any legal force in the context of state-held public listed companies.

The concept of the "stakeholder" has only appeared in China in the past ten years.[129] The China Corporate Governance Report 2007 cast its attention toward stakeholders, which were set as a research topic for 2007.[130] Employees are perhaps the most significant stakeholders expressly named by the *Code*. This research on the state-controlled model in China discusses employee as a chief element of the stakeholder model.

2.2.3 Employees

Employees, as crucial corporate stakeholders, have three categories of rights to participate in corporate governance: labor standards at the shop floor, as shareholders and representatives on the board of directors and board of supervisors, and free association and collective bargaining through trade unions.[131]

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[128] *Ibid*. Art.83.
[129] *Ibid.* at 140.
[130] The *China Corporate Governance Report* has been issued each year focusing on one specific topic in relation to corporate governance since 2003, general report of corporate governance in 2003, board of directors in 2004, State-held listed company in 2005, private listed company in 2006, transparency and information disclosure in 2008, and market for corporate control in 2009.
[131] Marleen O'Connor, "Labor's Role in the American Corporate Governance Structure" (2000) 22 Comp. Lab. L. & Pol'y J. 97, at 98. See also Barbara A. Lee, "Collective Bargaining and Employee Participation: An Anomalous Interpretation of the National Labor Relations Act", (1987)38 LAB. L.J. 206; Michael C. Harper, "Reconciling Collective Bargaining with Employee Supervision of Management" (1988) 137 U. Pa. L. Rev. 1. For comparative research of the employee's rights, see Linda L. Rippey, "Alternatives to the United States System of Labor Relations: A

A. Labor standards

The age of globalization has brought not only fairer and freer trade, but also greater concern and more care for human beings: "Most workers are facing job losses, job security, unsafe working conditions, declining social services, and stagnating wages."[132] Weak groups, and especially women, children, disabled people, and minorities, must be prevented from falling into complete poverty and further social polarization.

Since 1919, the International Labour Organization has maintained and developed a system of Conventions and Recommendations on international labour standards that aims to improve working conditions, employment opportunities, and social security across the world. The "core labour standards" comprise the eight Conventions of the International Labour Organization, which can be divided into four main themes: union rights, forced labour, discrimination, and child labour. These eight Conventions have been identified by the ILO's Governing Body as being "fundamental to the rights of human beings at work"[133] and are reflected in the *ILO Declaration on Fundamental Principles and Rights at Work* and its Follow-Up Procedures in 1998, which obligate all ILO member states to respect basic worker rights. As at 31 January 2003, all 175 member states of the International Labour Organization had ratified at least one of the eight fundamental conventions, and 84 had ratified all of them.

China has ratified four of the eight Conventions, mostly on discrimination and child labour.[134] The *Labor Law* stipulates that employees have the right to be treated on an equal basis in terms of employment opportunities, remuneration, taking rests,

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Comparative Analysis of The Labor Relations Systems in The Federal Republic of Germany, Japan, and Sweden" (1988) 41 Vand. L. Rev. 627.

[132] Steven Shrybman, *The World Trade Organization: A Citizen's Guide* (Ottawa: Canadian Centre for Policy Alternatives; Toronto: James Lorimer, 1999), at 96.

[133] It is stated by the ILO on its website: http://www.ilo.org

[134] *Ibid.*

having holidays and leave, receiving safety and sanitation protection, having professional training, enjoying social insurance and welfare, and filing applications for dispute settlement.[135]

Ensuring labor standards in China is not a problem of improving current labor standards, but of how to meet those standards in practice. Despite the strenuous and persistent economic reform in China, labor standards need to be met in all regions. Labor laws and regulations require more detailed drafting to meet international norms and practices, complemented by more specific rules on social security, employment, trade union and collective bargaining. Union rights, which are the most disputed standards, must be respected through the establishment of a tripartite structure in enterprises for equal negotiation and protection. Finally, promoting rational employment, raising wages gradually to fair levels, and improving the inefficient social insurance system are the most important approaches to achieve core labor standards.

B. Participation in corporate governance

Employees can participate in corporate governance either by representation on the board of directors or board of supervisors or by owning shares in a company. Such participation may reduce information asymmetry,[136] constrain the discretionary power of management,[137] and promote fairness in decision-making.[138]

(A) Representation

[135] *Labor Law of PRC*, with effect from January 1, 1995, Sec.3.
[136] *Supra* Note 38, at 60.
[137] *Ibid.* at 62.
[138] *Supra* Note 45.

Pursuant to the *PRC Company Law*, the required level of employee representation on the two boards is different: the board of directors can choose to have employee representatives as directors,[139] whereas the board of supervisors must have shareholder representatives. The percentage of employee representatives on the board of supervisors must account for no less than one third of all supervisors, and must be specified in the articles of association.[140]

(B) Stock ownership

Awarding employees with shares is one of the exceptional circumstances under the *PRC Company Law* in which a company can repurchase its own shares, subject to approval at a shareholders' meeting.[141] It is required that the source of funding for such buy-backs must be the after-tax profits of the company. Further, the shares repurchased by the company must not exceed 5% of the total shares already issued, and must be transferred to the employees within 1 year.[142]

C. Trade union

(A) Trade union rights as one of the eight core labour standards

Trade union rights mainly comprise two aspects: freedom of association and collective bargaining. The *Freedom of Association and Protection of the Rights to Organize Convention* ensures the right to "establish and, subject only to the rules of the organization concerned, to join organizations of their own choice without previous

139 *Supra* Note 4, Sec.109.
140 *Ibid.* Sec.118.
141 *Ibid.* Sec.143.
142 *Ibid.*

authorization,"[143] "to draw up their constitutions and rules, to elect their representatives in full freedom, to organize their administration and activities and to formulate their programmes."[144] Article 1 of the *Rights to Organize and Collective Bargaining Convention* provides that "workers shall enjoy adequate protection against acts of anti-union discrimination in respect of their employment."

Trade union rights are established for employees because they run the risk from employers "across the world, both public and private, of outright dismissal, wage cuts, bonus suspension, arbitrary transfers, harassment tactics."[145] Against today's global background of market competition and trade liberalization, the contradiction between the pursuit of maximum profits by employers and the maximum benefits expected by workers worsens the relationship of contracting parties. The rights of free association and collective bargaining offer a weapon of power to workers. Such rights also help "build balanced economic growth, sustain purchasing power, improve human resource development, and divert wages to health and education investment."[146]

(B) China

Historically, the working class in China has been respected and admired as the leading class since the liberation and establishment of the PRC in 1949. Employees have the right to participate in and organize trade unions in accordance with the *Labor Law.*[147] Trade unions should represent and safeguard the legitimate rights and interests of employees. There are two kinds of contracts between employers and

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[143] *The Freedom of Association and Protection of the Right to Organize Convention*, 1948 (No. 87), Art.2,
[144] *Ibid*. Art. 3.
[145] International Labour Office, *Fundamental Rights at Work: Overview and Prospects* (Geneva: International Labour Office, 2001), at 33.
[146] Ozay Mehmet, Errol Mendes & Robert Sinding, *Towards a Fair Global Labour Market: Avoiding a New Slave Trade* (Routledge, 1999), at 93.
[147] *Supra* Note 135, Sec.7.

employees: “labor contracts” that individual employee enter into with an employer, and “collective contracts” that are entered into by the trade union of the company or by a group of employees by themselves together with the employer if there is no trade union.

a. Labor contract

One of the functions of the trade union of a company is to assist and direct employees, who are entering into the labor contracts with employers.[148] When an employer unilaterally dissolves a labor contract, it must notify the trade union of the reasons in advance. If the employer violates the law or a labor contract, the trade union has the power to require the employer to engage in ratification. The employer must “consider” the opinion of the trade union and notify it of the result in writing.[149] The word “consider,” however, is quite vague. In a legal sense, “consider” means “advisory,” rather than “mandatory.” In other words, the trade union has no actual authority to change corporate decisions.

b. Collective contracts

The employees of an enterprise may get together as a party to negotiate with their employer to make a collective contract on matters of remuneration, working hours, breaks, vacations, work safety and hygiene, insurance, and benefits. The draft of the collective contract must be presented at meetings attended by all employees for discussion and approval.[150] The collective contract may also be entered into with the employer by the trade union on behalf of employees where the company has set up a

[148] *PRC Labor Contract Law*, with effect from 1 January, 2008, Sec.6.
[149] *Ibid.* Sec.43.
[150] *Ibid.* Sec.51.

trade union.[151]

The trade union supervises the employer's fulfillment of labor contracts or collective contracts. If an employee applies for arbitration or files a lawsuit, then the trade union should "give support" to employees.[152] The word "support" here is also unclear, and it is not specified what kind of support should be given, and the extent to which the support will be considered appropriate to protect employees. The laws and regulations similarly do not specify the circumstances in and the procedures by which trade union can protect employees.

Collective labor action is still rare in China, although there have been strikes and protests in the form of collective demonstration, petitions, and sit-ins at the entrances of government offices in some cities and towns.[153] China is now taking its first steps toward maintaining the employment rate and advancing nationwide social insurance reform. However, the trade unions in China are still strictly controlled by government,[154] a fact condemned in the surveys and reports of the ICFTU and

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[151] *Ibid.*

[152] *Ibid.* Sec.78.

[153] Christopher Candland & Rudra Sil, *The Politics of Labor in a Global Age: Continuity and Change in Late-industrializing and Post-socialist Economies* **(**Oxford University Press, 2001) at 193.

[154] The "Party-dominated trade union system" as the basic enforcing mechanism of protecting labour rights reflects the Chinese Communist Party's "concern with political control". Pitman B. Potter & Jianyong Li, "Regulating Labour Relations in China: The Challenge of Adapting to the Socialist Market Economy" (1996) 37 C. de. D. 753 at 773-5. Recently, trade unions of many foreign companies whose have China-incorporated subsidiaries have been challenged by their employees and media for their omissions for protecting the rights of works. See "Honda Challenges the Might of Chinese Trade Union", available at: http://timesofindia.indiatimes.com/business/international-business/Honda-challenges-the-might-of-Chinese-trade-unions/articleshow/6046899.cms; see also "Foxconn Needs a Better Trade Union, available at: http://tech.fortune.cnn.com/2010/06/03/foxconn-needs-a-better-trade-union/

OECD.[155] The Chinese government was even brought up before the ICFTU on a charge of acting against workers' rights activists.[156]

(C) Problems in China

Workers in China are largely unaware of their legal rights, and are not familiar with how to exercise their rights by law. Most labor protests are spontaneous and are not organized by trade unions or through normative procedures.[157] The current employment contract has administrative characteristics that are different from general commercial contracts between equal parties and create a power disparity between employers and employees. There is a lack of effective mechanisms for resolving labor disputes, because the current remedial approaches strictly follow a process that starts with internal mediation (no time-line limit by law) and continues to arbitration (45-60 days[158]) and then to litigation (court of first instance: 6-12 months; court of appeal: 3 months[159]). This process is time and cost consuming, making it difficult for economically disadvantaged employees to take measures to fully protect their rights.

The state-controlled model as applied to the state-held listed companies is

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[155] See ICFTU, Annual Survey of Violations of Trade Union Rights (ICFTU, 2000); OECD, *International Trade and Core Labour Standards* (Paris: OECD, 2000). See also Ozay Mehmet, Errol Mendes & Robert Sinding, *Towards a Fair Global Labour Market: Avoiding a New Slave Trade* (Routledge, 1999), at 148. According to the annual survey from the International Confederation of Free Trade Union (ICFTU), the violation occurs highly in developing countries. And the worst problems are in China, Egypt, Indonesia, Malaysia and other Asian and African countries. See Peter Morici, *Worker's Rights and Global Trade* (The International Economy, 2001).

[156] See "China: ICFTU deeply concerned at subversion charges against worker rights activists**"** (January 13, 2003), available at: http://www.icftu.org/displaydocument. asp ?Language=EN&Index=991216982

[157] Chan, Anita, "Labour Standards and Human Rights: The Case of Chinese Workers under Market Socialism" (1998) 20 Hum. Rts. Q. 886, at 889-90.

[158] Sec.3, *Law of Mediation and Arbitration on Labor Disputes*, with effect from 1 May 2008.

[159] Sec.135 and 159, *Civil Procedure Law of PRC* (revised 2007), with effect from 28 October 2007.

connected with China's overall management of state-assets during the economic transition from a state-planned to a market-oriented economy through SOE reforms. The political and economic underpinnings of the state-controlled model will be discussed in the next chapter. The hallmarks of the model, that is, two-tier shareholding and a two-tier board in state-held listed companies, are explored in Chapters IV and V.

Chapter III Underpinnings of the State-Controlled Model

> "Throughout the world, the development of markets has often been related, if not to historical accidents, at least to the course of political and economic developments and geographical imperatives."
>
> Paul Horsnell, *Oil in Asia: Markets, Trading, Refining and Deregulation* (Oxford University Press, 1997)

China's development in the past three decades has focused on its economic growth,[160] but legal reform has also been undertaken since the early 1990s to build a preliminary framework for the rule of law.

The state-controlled model, as a corporate governance model for state-held listed company, chiefly relates to how well the state assets of China are managed, which is at the very "intersection" of political control and economic reform.[161] The state-controlled model has been underpinned by the government's political control and SOE reform in China, and is also connected with state asset management on a multi-level administrative basis.

3.1 Political control by government

[160] Randall Peerenboom, "The Fire-Breathing Dragon and the Cute, Cuddly Panda: The Implication of China's Rise for Developing Countries, Human Rights, and Geopolitical Stability" (2006) 7 Chicago Journal of International Law 17, at 20.

[161] Angus Young, Grace Li & Alex Lau, "Corporate Governance in China: The Role of the State and Ideology in Shaping Reforms" (2007) 28(7) Company Lawyer 204, at 211. Roe (2006) makes his argument that the political economy rather than legal origin clarifies the essentials of different financial markets. In his view, company law is less important than political and economic policy to support the development of modern market, although those laws concerning property rights and shareholder protection are related to the maturity of market. See Mark J. Roe, "Legal Origins, Politics, and Modern Stock Markets" (2006) 120 Harv.L.Rev. 460, at 462. See also Mark J. Roe, "Some Difference in Corporate Structure in Germany, Japan, and the United States" (1993) 102 Yale L.J. 1997, at 464-5, 1997-8.

3.1.1 Overview

Politics is the major force shaping the state-controlled model of corporate governance for state-held listed companies in China.[162] China is a unitary state in terms of power distribution structure. Local power is redistributed by the central authority, and is directed and supervised by the central authority, thus creating a uniform and efficient administration.

National security and state sovereignty, which give China independent decision-making power, are regarded as primary by Chinese leaders. However, since China's entry into the WTO, intense competition and trade liberalization have had an impact on national agriculture and SOEs.[163]

The political institutions broadly deal with the power-distribution structure, political party organization, and public arrangements.[164] However, in this thesis, the functions of the government that are discussed are limited to those connected with corporate governance.

John Adams believes that "good government is an empire of laws."[165] The famous Chinese jurist Jiang Ping states the limitations of both the public rights of governments and the private rights of private entities: "private rights may have more

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[162] Sonja Opper & Sylvia Schwaag-Serger, "Institutional Analysis of Legal Change: The Case of Corporate Governance in China" (2008) 26 Wash. U. J.L. & Pol'y 245, at 250.

[163] Personally, I believe stability and independency should be always pursued by every country in the world; otherwise, a nation has lost the meaning of its subsistence, tracing the emergence of nation as an inevitable result of social division and property ownership.

[164] Ho Khai Leong, *Reforming Corporate Governance in Southeast Asia: Economics, Politics and Regulations* (Singapore: ISEAS, 2005), at 26.

[165] "Thoughts on Governments" (1776) in Kennith M. Dolbeare (Complier), American Political Thought (Chatham House Publishers, 1996) 64-8.

freedom to be exercised but they are always subject to the discipline of the market as the "invisible hand" and government intervention as the "visible hand." Public rights may have more definite norms to be followed, but they may be involved with the individual will of the decision-maker."[166] The relationship between government and corporate governance is governed by the mutual interplay between public governance and corporate governance, which, when positive, can create a combined force to support economic development.[167]

The relationship of government to corporate governance is a dynamic and interactive process[168] in which the government plays the roles of both regulator and participant.

A. Government as regulator

As a regulator, the government can control or affect the private sector through business policies and taxation systems.[169] The government in China exerts a unique influence by means of issuing statutory regulations to strike a balance of interests between and among shareholders and stakeholders,[170] and may prevent or punish any

[166] Jiang Ping, *To Shout is My Duty* (Law Press China, 2007) (in Chinese), at 3.
[167] James Thuo Gathii, "Retelling Good Governance Narratives on Africa's Economic and Political Predicaments: Continuities And Discontinuities In Legal Outcomes Between Markets And States" (2000) 45 Vill.L.Rev. 971, at 1008.
[168] See Qian Yingyi, "Government Control in Corporate Governance as a Transitional Institution: Lessons from China" in Boris Pleskovic & Joseph Stiglitz (edited), *Annual World Bank Conference on Development Economics 1999* (The World Bank, 2000) 289.
[169] Joseph E. Stiglitz, "Regulating Multinational Corporations: Towards Principles of Cross-Border Legal Frameworks in a Globalized World Balancing Rights with Responsibilities" (2008) 23 Am. U. Int'l L. Rev. 451, at 499.
[170] Hemraj, Mohammed B., "Corporate Governance: Rationalising Stakeholder Doctrine in Corporate Accountability" (2005) 26 Company Lawyer 211, at 212.

expropriation and abuse resulting from unsound governance. The government estimates and adjusts its economic policies and revises its policies.[171] Listed companies must thus keep up to date and comply with the regulations promulgated by the government.

B. Government as participant

The government may have a majority shareholding interest and exclusive access to resources in listed companies with a state-shareholding structure.[172] In terms of its "participant" role as a controlling shareholder, governments always have a "comparative advantage" to achieve resources.[173] The effectiveness of participation is premise on the existence of a good government that is transparent and responsible.

3.1.2 Bank-based model

One of the disadvantages of state-controlled ownership is the government's interference in the banks' business. In China, the government still exercises control over loan agreements between "big-four" commercial banks and state-held listed companies. Governments often intervene in loan decisions.[174] This controlling influence is also felt through the macro-economic policies of the central government and their implementation by local governments, who are under pressure to meet their

[171] Neo Boon Siong & Geraldine Chen, *Dynamic Governance: Embedding Culture, Capabilities and Change in Singapore* **(**Hackensack, N.J.; Singapore: World Scientific, 2007), at 54.
[172] Ho Khai Leong, *Reforming Corporate Governance in Southeast Asia: Economics, Politics and Regulations* (Singapore: ISEAS, 2005), at 17.
[173] *Supra* Note 168.
[174] *Supra* Note 162, at 265.

annual GDP targets. Administrative interference in decision-making about loans has given rise to banks "absorbing bad loans from non-performing SOEs."[175]

The "big-four" commercial banks are not autonomous financial institutions, but rather are instruments that the government uses to control the market, and especially SOEs, for the political necessity of maintaining stability and employment.[176] This is a regular practice in transitional economies. The banks become "transfer agents" that transfer funds only in order to meet "state-initiated commitments."[177] As the former chairman of the Federal Reserve Board, Alan Greenspan, recognized, inefficient SOEs, which control listed companies, may bring the banking systems into unexpected crisis.[178]

Whether banks as creditors are able to effectively monitor corporate business thus depends on the presence of effective banking regulations and banking practices.[179] The current responsibility of China's banks to check debtors is passive, in that they only check a corporation's financial credit and the operations of the supervisory board.[180] Thus, in practice, the use and repayment of bank loans are not

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[175] Angus Young, "Conceptualising A Chinese Corporate Governance Framework: Tensions between Tradition, Ideologies and Modernity" (2009) 20(7) I.C.C.L.R. 235, at 240.

[176] Masabiko Aoki, "Controlling Insider Control: Issues of Corporate Governance in Transitional Economies", in *Corporate Governance in Transitional Economies: Insider Control and the Role of Banks* (edited by Masahiko Aoki & Hyung-Ki Kim) (The World Bank, Washington D.C. 1995), at 24.

[177] Alan Greenspan, *The Age of Turbulence: Adventures in a New World* **(**New York: Penguin Press, 2007) at 308.

[178] *Ibid.* at 302.

[179] *Supra* Note 2, at 40-1.

[180] *Supra* Note 47, at 63.

transparent.[181]

3.1.3 Stakeholder model

In the process of SOE reform, the question arises as to how well the government has coped with its changed role of being separated from enterprise but still monitoring business entities to some extent, and how it has dealt with the contradictions between traditional social equality and intense market competition. These questions are connected to other issues such as the loss of state assets, rising levels of unemployment, and the emergence of social upheaval.[182]

Further to one of the disadvantages of state controlled ownership in the bank-based model having been discussed above in 3.1.2, the other disadvantage of state-controlled ownership is that governments may exercise their controlling power for multiple social purposes with little consideration of economic efficiency.[183] The goals of state control of an enterprise are both commercial (wealth maximization for shareholders) and non-commercial, such as the maintenance of urban employment levels and the direction of sensitive industries.[184] The government is also concerned with local economic growth and the development of municipal infrastructure, which is included in the evaluation indexes for the performance of local governments. The

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[181] People's Bank of China, "China Financial Market Development Report 2005" (in Chinese), available at the website of PBOC: http://www.pboc.gov.cn

[182] Ross Garnaut, *China's Ownership Transformation: Process, Outcomes, Prospects* (Washington, DC: The International Finance Corporation and the International Bank for Reconstruction and Development, 2005) at 32.

[183] EC Chang & SML Wong "Political Control and Performance in China's Listed Firm" (2004) 32 Journal of Comparative Economics 617, at 618-9.

[184] See Clarke, Donald C., "Corporate Governance in China: An Overview", Working Paper, July 2003; *Supra* Note 162, at 251.

state-controlled model, which is founded on the stakeholder model to some extent, is characterized in the inconsistent pursuit of often conflicting multiple targets at different levels of government and across different regions. Any SOE-affiliated companies within the same group, including state-held companies, share the burden of achieving the various social objectives of SOEs. This thesis examines the specific objective of employment.

A. SOEs and the social insurance program

In terms of political ideology in China, consciousness of social class ("*Jie Ji*") and communist collectivism are highly valued. The employee, who is assigned to the "worker's class" ("*Gongren Jieji*"), is recognized by the Preamble of the *PRC Constitution* as the "leading class" since the liberation of China and the establishment of the People's Republic of China (PRC) in 1949.

The social insurance system in China was established in 1951 to cover pensions, medical services, and worker's injuries. Under this system, SOEs bear a heavy burden of social responsibility as both manufacturing entities and social welfare providers.[185]

For a long time, "unemployment" was not officially recognized in any socialist countries and was believed to be an exclusive phenomenon existing only in capitalist societies. At that time, those who had no jobs were deemed to be "waiting for jobs." National policies such as the "uniform assignment of jobs" and "low wages and a high rate of employment" were put in place to solve the problem of unemployment. All

[185] Vicky Lee, *Unemployment Insurance and Assistance System in Mainland China*, available online**:** http://www.legco.gov.hk/yr99-00/english/sec/library/e18.pdf**,** at 11.

workers were paid equally under the policy of the "iron rice bowl," which was neither fair nor efficient.

The unemployment insurance (UI) system in China was first established in 1986 when the *Interim Provisions on Unemployment Insurance for Staff of State Enterprises*[186] were promulgated by the State Council. In 1993, *the Regulations on Unemployment Insurance for Staff and Workers of State-owned Enterprises*[187] were enacted. These regulations extended the scope of the beneficiaries of UI to seven types, and provided for the collection and management of the UI fund. However, they still emphasized SOEs, and ignored unemployment in other types of enterprises, in this not being substantially different from earlier regulations. Since 1994, the establishment and perfection of the socialist market economy has been set as the objective of economic reform in China. As there are large numbers of displaced employees, further improvement of unemployment insurance system is vital. In 1999, the State Council promulgated the *Unemployment Insurance Regulations*, which were a "revision, supplement and amendment" of the 1993 *Regulations*.[188] Under the revised regulations, all unemployed staff and workers in business entities in urban areas, including state-owned enterprises, collective enterprises, foreign-funded enterprises, and private enterprises, are covered by unemployment insurance.

B. Urban layoffs

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[186] *Ibid*.
[187] See online: http://www.qis.net/chinalaw/prclaw66.htm
[188] *Supra* Note 185.

Since 1994, economic reform has centered on the development of the market economy and the encouragement of competition in the domestic market. The increasing rate of unemployment has also been pushed to the top of the agenda. The "unemployment rate" was noted in the State Statistics Report in 1994 for the first time.

The transition from state-planned to market-oriented economy has resulted in "urban layoffs." "Urban layoffs" refer to "permanent workers of state-owned enterprises who had been employed before the labor contract system was established in China or whose labor contracts have not yet expired, [who] are laid off from their working positions for retrenchment. Their labor relations with SOEs have not been terminated."[189]

To alleviate the problem of "urban layoffs," the "Project of Reemployment" was initiated as a state policy. This project requires that every SOE establish a reemployment center that has three main functions. The first is distributing maintenance fees for layoffs which are provided jointly by the enterprise, government subsidy, and the UI fund (from UI agencies). The second is paying UI premiums for layoffs, and the third is helping laid-off employees to seek reemployment through job direction and training.

At present, "urban layoffs" are not included in the unemployment rate. The Project of Reemployment is a policy with Chinese characteristics under current national conditions, and represents a temporary stage in the transfer of layoffs from

[189] Yang Guang, *Facing Unemployment: Urban Layoffs and the Way Out in Post-reform China (1993-1999): An Empirical and Theoretical Analysis* (Hague: Institute of Social Studies, 1999), at 7-8.

SOEs to the market. However, increasingly the term "urban layoffs" is being replaced by "unemployment" in line with the progression to a market economy.

3.2 Economic reform – SOE reform

The official economic growth rate in China rose from 8% in 2002 to 11.4% in 2007 following China's entry into the WTO in late 2001. China's GDP in 2007 reached US$3.2 trillion, making it the world's fourth largest economy after the USA, Japan, and Germany.[190] In 2007, 74.8 billion US dollars of foreign investment was put into use, an increase of 13.6% over the figure for 2006.[191] China is stimulating its economic rise by expanding both export trade, mainly based on consumer goods, and domestic private consumption, although China's economic growth has been slowed by the global economic downturn since late 2008.

3.2.1 Overview of SOEs

There are three types of SOEs in China: (1) special enterprise, incorporated under the *Law of the People's Republic of China on Industrial Enterprises Owned by the Whole People* ("*IEOWP Law*"), is run by the government for national defense, infrastructure, and other sectors of public interest; (2) solely state-funded company ("*Guoyou Duzi Gongsi*"), which is a specific kind of limited liability company under the *PRC Company Law*, is 100% owned by the state. The SASAC are authorized by the State Council or the local people's government to act as the investor for

[190] Statistics from National Bureau Statistics of China, available at: http://www.stats.gov.cn

[191] Statistics from Ministry of Commerce , available at: http://www.mofcom.gov.cn

supervising state-owned assets[192]; and (3) state-held company (inclusive of its subsidiaries, affiliates and branches), which is incorporated either as limited companies or as joint stock limited companies, includes listed and non-listed state-held companies. A solely state-funded company or the SASAC (or its provincial-level branch) on behalf of the state is the controlling shareholder of the state-held companies.[193]

Based on political orientation (for example, privatization in the former Soviet Union and Eastern Europe) and financial orientation,[194] SOE reform can have a range of targets, including the promotion of firm efficiency,[195] relieving public budgets, the reduction of managerial abuse, or the improvement of resource allocation.[196]

In China, the main purpose of SOE reform is to raise capital to overcome the financial losses and operational inefficiency of SOEs, which have caused and

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[192] *Supra* Note 4, Sec.65.

[193] See the *Opinions on the Determination of State-owned Enterprises*, issued by Ministry of Finance, with effect from 23 April, 2003. Since 2006, the SASAC has directly held shares in state-held listed companies, rather than being an investor in the non-listed holding companies. See *infra* Note 258.

[194] See Shahid Yusuf, Kaoru Nabeshima & Dwight H. Perkins, *Under New Ownership: Privatizing China's State-owned Enterprises* **(**Palo Alto, CA: Stanford University Press, 2006), Chapter 6.

[195] Clarke, Donald C. "Corporate Governance in China: An Overview" (July 15, 2003), available at SSRN: http://ssrn.com/abstract=424885

[196] Shahid Yusuf, Kaoru Nabeshima & Dwight H. Perkins, *Under New Ownership: Privatizing China's State-owned Enterprises* **(**Palo Alto, CA: Stanford University Press, 2006), at 13. It is concluded by the book that there are four reasons for the priority of SOEs reform: first, "to stem the direct coasts to the economy from the inefficient use of resources"; second, "to protect the health of banking system"; third, "to facilitate and promote the reform of market"; fourth, "to heighten the responsiveness of the SOEs to market forces".

accumulated a large amount of NPLs in the commercial banks.[197] SOE reform has involved the corporatization and privatization of SOEs. SOEs are able to take profitable assets into newly incorporated companies which are then listed on the stock exchanges as state-held listed companies.[198]

"Holistic" listing has been increasingly encouraged by the Chinese government since 2004[199] to facilitate the restructuring of the central SOEs undergoing reform. Holistic listing means the listing of the whole group, rather than a single company of the group. This form of listing reduces the risk of tunneling from listed subsidiaries by the controlling shareholder, because the holding company of the group is subject to the same level of transparency as that of all other listed companies, and interests are centered on the same group.

Eighty percent of the assets of the central SOEs have been capitalized into state-held listed companies.[200] The statistics of the *China Corporate Governance*

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[197] Maxim Boycko, Andrei Shleifer & Robert W. Vishny, "A Theory of Privatisation" (1996) 106 Economic Journal 309. See further Zhang Wenkui, *China SOEs Reform and Transformation of Corporate Governance* (China Development Press, 2007) (in Chinese), at 198.

[198] *Supra* Note 176, at 234. The book states that "[R]eforming governance of SOEs in China can viewed as a three-step process: corporatization, rearrangements of corporate control, and privatization. At the present time, the first two steps are feasible, but privatization is restricted to small-scale firms".

[199] *Notice of the China Securities Regulatory Commission on the Relevant Work of Further Regulation of Initial Public Offering* (issued by the CSRC, No. 116 [2003]) , which requires the issuer company shall be incorporated at least for three years before it is to apply for IPO. But this requirement is not applicable to integrated listing of those corporate groups, which are previous SOEs. Although the regulation has been expired, the policy to encouraging integrated listing are implicated by many Chinese officials' speeches published by the news media, such as Li Rongrong, Chairman of the SASAC, on January 6th, 2007, Shanghai Securities Daily.

[200] The speech of Li Rongrong, "Direct holdings by the SASAC", 19 December 2009, available at: http://www.news.cn.

Report 2009[201] show that around two thirds of the companies listed on the Shanghai Stock Exchange at the end of 2008 were state-held listed companies. According to Mr. Li Rongrong, Chairman of the SASAC, "the state-held listed company is an essential component of SOEs." As at the end of 2008, the number of state-held listed companies had reached 900, and their assets, turnovers, and profits accounted for 29.2%, 40.9%, and 54.4% that of all SOEs, respectively.[202]

SOE reform in China features three unique characteristics that are distinct from those of similar reforms in Western countries and East European countries. First, SOE reform in China is connected with China's economic transition from a state-planned to a market-oriented economy. Second, local governments have taken great responsibility for developing the local economy to further open it up to the outside world under governmental decentralization.[203] Third, the privatization of SOEs in China has taken a gradual and informal approach. In the process of reform, numerous SOEs have failed to meet operational targets and are on the brink of bankruptcy. How the government manages such national assets is a crucial issue to the autonomy and vitality of state-held listed companies.

3.2.2 Three Characteristics of SOE Reform

A. China's economic transition from a state-planned to a market-oriented economy

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[201] *Supra* Note 27, at 76.
[202] *Supra* Note 200.
[203] *Supra* Note 197, *Zhang Wenkui*, at 141.

The past thirty years have witnessed a gradual[204] and complex process of SOE reform in China in accordance with multiple and conflicting objectives. The adjustment of the institutional framework and policy by cautious degrees has ensured the stable persistence and progress of reform[205], which runs contrary to the radical privatization in Czech.[206]

The course of SOE reform in China can be divided into two phases.[207] The first was an experimental stage governed by trial and error that ran from 1979 to 1992 alongside the opening-up policy and economic reform. The second phase is from 1993 until the present, which has seen the launch of corporatization following the promulgation in 1993 of the *PRC Company Law*. The classic governance structure involving a general meeting, board of directors, and management did not take shape until the legitimization of corporatization by the first Chinese *Company Law* in 1993.[208] China has made great efforts since the early 1990s to establish a socialist market economy with Chinese characteristics. During this transitional process, continuously deepening SOE reform has been initiated to promote efficiency,

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[204] Wu Jinglian, renowned economist in China, agrees that "China's reforms are complex, integration and combination of gradual and radical process", concluded in his book *Gradualism and Big Bang: The Choice of China's Path to Reform* (Beijing: Economic Science Press, 1996) (in Chinese).

[205] Lan Cao, "Chinese Privatization: Between Plan and Market" (2000) 63 Law and Contemporary Problems 13. The author thinks the institutional framework of China differs from that of Eastern European countries.

[206] John C. Coffee, Jr. "Privatization and Corporate Governance: The Lessons from Securities Market Failure" (1999-2000) 25 J. Corp. L. 1, at 10-11.

[207] See for example Teh Hooi Ling "Price of using Stock Options" The Business Times, 24 August, 2002; See also Melvin Avon Eisenberg, "The Structure of Corporate Law" (1989) 89 Colum. L. Rev. 1461, at 55.

[208] The *PRC Company Law 1993* was repealed and superseded by the *PRC Company Law* (2006).

profitability, and accountability by means of re-construction, mergers, privatization, or bankruptcy of unprofitable enterprises. Subsequently, more fierce market competition is leading China to re-construct its labor-management nexus and re-distribute social resources.

The landmark dividing these two phases is the memorable tour of Southern China by Deng Xiaoping in 1992, when he delivered various speeches that determined the nature of China's economic reform, placing reform in the foremost position and underscoring that it depended on the concomitant development of science and technology and education. The well-known theory advanced by Mr. Deng was that the choice between a state-planned economy and a market-oriented economy should not be the essential difference between capitalism and socialism. They are two kinds of economic instruments available to any country. He further provided three criteria to evaluate the success of reform: (1) whether productivity has been boosted; (2) whether comprehensive national power has been enhanced; (3) whether people's living standard has been improved.[209] Deng Xiaoping's speeches have served as the theoretical foundation for solving the long-term debate on the ideological issue of SOE reform and the move toward free trade.[210]

Deng's notion of socialism with Chinese characteristics was interpreted by Hu Jintao, President of China and General Secretary of the Communist Party, as

[209] It is available at: http://cpc.people.com.cn/GB/33837/2535034.html

[210] The OECD recognizes that SOEs usually "represent substantial part of GDP, employment and market capitalization", and "governance of SOEs will be critical to ensure their positive contribution to a country's overall economic efficiency and competitiveness". See *OECD Guidelines on Corporate Governance of State-owned Enterprises* (2005), at 9.

"undertaking economic development as the central task and making a harmonious society with socialist democracy and culture."[211] This centralization of economic development and opening up is the successor to the core tenets of the second and third generation of leaders of China, Deng Xiaoping and Jiang Zemin, after the first generation of Mao Zedong.

B. Decentralization

China is a unitary state in which the authority of local governments is redistributed from the central government and is directed and supervised by the central authority, and national security (stability) and state sovereignty (independency) are paramount.

The latest *Guidelines of the Eleventh Five-Year Plan (2006-2010) for National Economic and Social Development* pushes the various government to accelerate the construction of "serving government, responsible government, and legally governing government."[212] Based on the "scientific concept of development" and "theory of harmonious socialist society" proposed by President Hu Jintao and Premier Wen Jiabao, the core leaders of the fourth generation, the political influence of government in the economics of the private sector is to be reduced and limited through the decoupling of government functions from enterprise management, asset management, and market mediation (expert and public consultation[213]).

Power distribution generally ranges from extreme centralization to complete

[211] Hu Jintao's Report was delivered at the 17th National Congress of the Communist Party of China on October 15, 2007.
[212] The Eleventh Five-Year Plan of China, Chapter 30, available at http://china.org.cn/english/features/guideline/156529.htm
[213] *Ibid.*

decentralization:[214] The power distribution structure in China is undergoing a transition from complete centralization to gradual decentralization, which is characterized by the following conditions concluded by Qian and Weingast: "(1) There exists a hierarchy of governments; (2) The sub-national governments have primary authority over the economy within their jurisdictions; (3) The national government has the authority to police the common market."[215] Applying these three conditions to China's current decentralization status, it can be concluded that the three conditions are basically satisfied.[216]

(A) First condition

China has traditionally been a nation of centralized power. Before the opening up commenced in 1978, local governments had no independent powers, especially economic autonomy, and instead were effectively "agents" of the central government[217] that operated on the administrative orders of the central authority. All fiscal taxation revenues had to be submitted to the central government, and government grants and funding resources (based on a certain proportion of the revenues submitted the year before) were then disbursed from the central to the local governments.

(B) Second condition

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[214] See Qiang Yingyi & Barry R. Weingast, "China's Transition to Markets: Market-Preserving Federalism, Chinese Style" (1996) 1 Journal of Policy Reform 149.
[215] *Ibid.*
[216] *Ibid.*
[217] Deng Wei, "The Relationship between Central and Local Government under decentralization" (in Chinese), available at: http://www.xzgl.net/xzll/zylw/xzlw06a/060208.doc

Since 1978, administrative power has been decentralized to local governments. Economic decentralization in particular has been a crucial step on the path of China's economic reform[218] whereby local governments have obtained more autonomy to develop local markets to relieve the burden of the central government. From a macroscopic perspective, concentration has been replaced with coordination between regions and adjustment across the whole economic system. The new vertical administrative hierarchy has motivated local governments to seek rapid and innovative growth, rather than passively executing the orders of Central government. From 1979 to 1993, fiscal revenues were distributed based on profit-sharing terms through contracts made between the central and local governments. Since 1994, a separate tax system has been adopted to meet the requirements of the new market economy. Under this new tax system, the central government is in charge of industries with national or trans-regional interests, but local governments have the right to collect taxes from entities more closely related to the local context.

(C) Third condition

In practice, the rights conferred on local governments may be unilaterally taken back by the central government at will by administrative order.[219] An "ad hoc" approach is adopted rather than a "rule-based" approach, and no systematic regulations are followed by the government in respect of decentralization.[220] In other words, the central government still maintains full discretion over policy-making in both the political and the economic sense.

[218] *Supra* Note 212.
[219] *Supra* Note 215.
[220] *Supra* Note 212.

C. Privatization

(A) Overview

From the economic perspective, privatization is a process in which state-owned property is transferred to the private sector.[221] Privatization is a national economic means to promote market efficiency to cure the "impaired profit-orientation" and maintain the "balance between the public and private" economy.[222]

Privatization is defined in a political sense as "a combination of the reallocation of control rights over employment from politicians to managers and the increase in cash flow ownership of managers and private investors."[223] The starting point of this argument is that the inefficiency of public enterprises is caused by political interference, rather than efficiency maximization, and thus privatization may work if it can control political abuse.[224]

State ownership is considered to be inconsistent with enterprise efficiency,[225] because bureaucrats have virtually total power over firms and can direct them to pursue any political objective. State ownership is then an example of concentrated control with no cash flow rights and socially harmful objectives.[226] Furthermore,

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[221] John White, "Privatization in Eastern and Central Europe" (2000) 13 Int'l. L. Practicum 19, at 19.

[222] John Hassard *et al*., *China's State Enterprise Reform: From Marx to the Market* (New York, NY: Routledge, 2007), at 17, 20. See also Katharina Pistor, "Patterns of Legal Change: Shareholder and Creditor Rights in Transition Economies"' in *Corporate governance lessons from transition economy reforms* (Edited by Fox, Merritt B. & Heller, Michael A.) (Princeton, N.J.: Princeton University Press, 2006).

[223] Maxim Boycko, Andrei Shleifer & Robert W. Vishny, "A Theory of Privatisation" (1996) 106 Economic Journal 309, at 310.

[224] *Ibid*. at 309, 318

[225] *Supra* Note 3, *Shleifer, Andrei & Vishny, Rober*, at 767.

[226] *Ibid*. at 768.

governments may be concerned with social stability, attracting investment, and securing a low unemployment rate.

(B) Privatization in China

The basic economic system in China aims to keep public ownership as the mainstay and allow diverse forms of ownership to develop synchronously.[227] The private sector of the economy was for the first time recognized by the *PRC Constitution*, in which it is referred to as the "individual economy," which is to exist and develop within the limits prescribed by law as a "complement to the socialist public economy" to be guided, supervised, and controlled by the state.[228] The *Amendment to the Constitution 1999*[229] changed the terms "complement" and "socialist public economy" to "constitute an important component of the socialist market economy." The latest *Amendment to the Constitution 2004*[230] supplements that the state shall encourage, support and guide the development of the private economy.

Since 2005, non-state capital has been expressly permitted by law to enter what were once monopoly industries, such as the public utilities and infrastructure, social

[227] Sec.6, *Constitutional Law of PRC*, adopted at the Fifth Session of the Fifth National People's Congress on December 4, 1982, and amended in 1988, 1999 and 2004.
[228] *Ibid*. Sec.11.
[229] It is adopted at the Second Session of the Ninth National People's Congress and promulgated for implementation by the Announcement of the National People's Congress on March 15, 1999.
[230] It is adopted at the Second Session of the Tenth National People's Congress and promulgated for implementation by the Announcement of the National People's Congress on March 14, 2004.

undertakings (education, scientific research, health, and culture), financial services, defense-related science and technology, and other fields not forbidden by law.[231] Moreover, non-capital capital is now allowed to participate in the structural adjustment of the state-owned economy and the reorganization of SOEs by Management Buyout (MBO).[232]

For China, privatization is informal rather than officially pronounced, because "privatization" is a sensitive term in the arena of economic reform. Other terms are often used, such as "corporatization," "ownership transformation," or "transformation of the system," which are considered more compatible with the Chinese ideology of "a socialist market economy with Chinese characteristics."[233]

Privatization is usually taken as "an indispensable element in Chinese SOEs reform."[234] In the process of SOEs reform, privatization is gradually progressing on a

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[231] Art.1-.6, *Several Opinions of the State Council on Encouraging, Supporting and Guiding the Development of Individual and Private Economy and Other Non-Public Sectors of the Economy*, issued by the State Council on February 24, 2005.

[232] *Ibid*. Art.7. The emergence of private listed company is synchronous with the establishment of capital market in China. In 1992, Shen Hua Yuan, as a private company, was listed on the Shenzhen Stock Exchange. In 1993, Fu Yao Glass was the first family-controlled private company listed in the Shanghai Stock Exchange.[232] But the number of private listed companies has been growing especially from 1999 onward, but the total number of private listed company is still small compared with state-held listed companies. As at 31 December 2004, there are 210 private listed companies in the Shanghai Stock Exchange There are 103 private listed companies, nearly half of all the 210 private listed companies in Shanghai Stock Exchange, are listed through IPO. Another 98 companies are previously SOEs or collective-owned enterprises and amalgamated by private business to be listed. The rest 9 companies are through MBO, i.e. transference of State-owned shares to management in listed companies. See more details in the Shanghai Stock Exchange, *China Corporate Governance Report 2005: The Corporate Governance of Private Listed Companies* (Fu Dan University Press, 2005) (in Chinese)

[233] *Supra* Note 205, at 13.

[234] *Supra* Note 222, *Katharina Pistor*.

limited scale,[235] with shares of SOEs after corporatization being "issued to the private investors while the state retains a controlling interest."[236] In this case, the professional managers of the previous SOEs enter into operational contracts with governments which give them the authority to manage the companies.[237]

In brief, the central government still retains macro-level control over the gradual progression of decentralization and privatization (along with SOE reform) in the transition from a state-planned to a market-oriented economy.

3.3 Managing state assets in China

3.3.1 Basic economic system and property rights

The current basic economic system in China is set out in the *Property Law of PRC*, according to which "public ownership plays a dominant role and diverse forms of ownership develop side by side in the socialist market economy system and safeguard the equal legal status and development rights of all market operators."[238]

The term "property" is defined by the *Property Law* as the "exclusive ownership

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[235] It is contrast to the "massive privatization" that occurred in the former Soviet Union countries. See Cole, Rebel A., Berkman, Henk and Fu, Jiang Lawrence, From State to State: Improving Corporate Governance Where the Government is the Controlling Block Holder (November 12, 2002). Available at SSRN: http://ssrn.com/abstract=370140, at 26.

[236] See Sharon M. Lee. "The Development of China's Securities Regulatory Framework and the Insider Trading Provisions of the New Securities Law" (2001) 14 N.Y. Int'l L. Rev. 1.

[237] *Supra* Note 168. Prof. Qian Yingyi is one of the earliest Chinese economists in the research of SOEs, introducing into China academia the concept of corporate governance. He makes a series of analysis on improving corporate governance of SOEs thorough controlling insiders and enhancing functions of banks.

[238] *Supra* Note 8, Sec.3.

of direct control enjoyed by the holder according to law over a specific *res*."[239] The assets owned by the state consist of "mineral deposits, waters, sea areas, urban lands and other lands prescribed by law, radio frequency spectrum resources, assets for national defense."[240]

In China, the administration of state assets by the government has a multi-level structure, as shown in Figure 3.1. On the first level, state-owned assets are recognized by the *Law of the People's Republic of China on the State-owned Assets of Enterprises* (the "*SOAE Law*") to be owned by the state, which means that they are owned by the people.[241]

On the second level, the State Council can, on behalf of the state, exercise the ownership of state-owned assets by performing "investor's duties and enjoy[ing] the rights and interests accordingly on behalf of the state."[242]

At the next level, the State Council may authorize the local people's governments to act as investors along with itself.[243] The State Council is in charge of central SOEs (typically large entities that are vital to the national economy, national security, major infrastructure, and essential natural resources), and local governments administer the remaining SOEs (usually small to medium-sized entities related to local industries).[244]

At the fourth level, the SASAC and local branches of the SASAC are authorized

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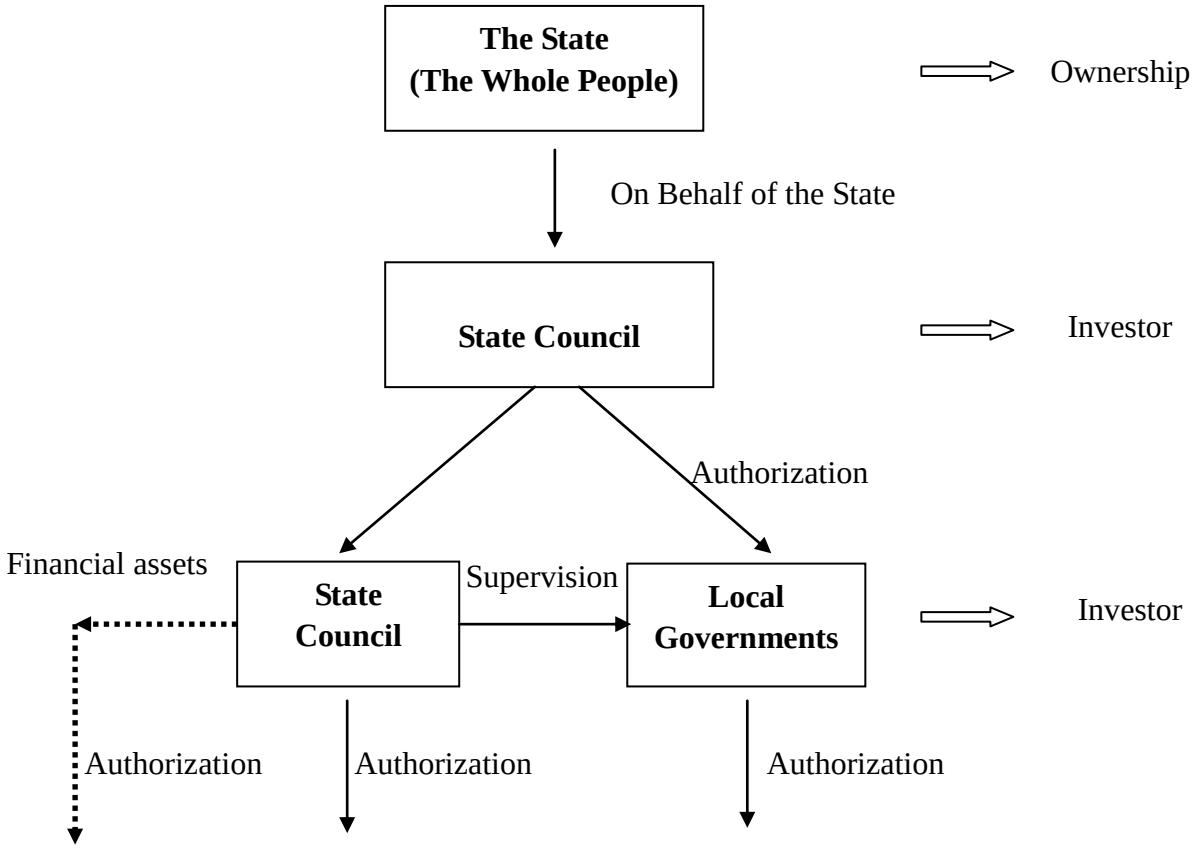
[239] *Ibid*. Sec.2.
[240] *Ibid*. Sec.45-52.
[241] It is adopted at the 5th session of the Standing Committee of the 11th National People's Congress of the People's Republic of China on October 28, 2008, and comes into force on May 1, 2009, Sec.3. See also Sec.45, *Property Law of PRC*.
[242] *Ibid*.
[243] *Ibid*. Sec. 4(1); Sec.55, *Supra* Note 8.
[244] *Ibid.* Sec.4(2).

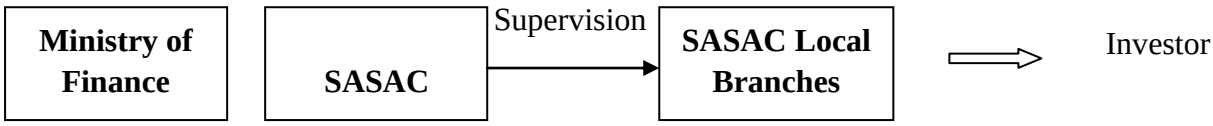
respectively by the State Council and local governments to manage and supervise SOE assets,[245] except those related to financial institutions (for example, banks, securities companies, and insurance companies), the administration of which is authorized by the Ministry of Finance.[246] The local branches of the SASAC are supervised by their respective governments and by the SASAC.

Figure 3.1 Hierarchy of State Assets Administration



[245] *Ibid.* Sec.11; See also Sec. 5, *Interim Measures for the Supervision and Administration of State-owned Assets of the Enterprises*, which were adopted at the 8th executive meeting of the State Council on May 13, 2003; Section 25-31, *Interim Measures for the Management of the Transfer of the State-owned Property Right of Enterprises* were adopted at the executive meeting of the directors of the State-owned Assets Supervisory and Regulatory Commission of the State Council, promulgated and effective as at 1 February, 2004.

[246] Considering the difficulties to clarify the complicated regulations on every specific financial institution, this thesis focuses on the SOEs supervised by the SASAC.



3.3.2 Separation of government bodies and enterprises

Corporate governance in SOEs in China has undergone a host of reforms. In addition to restructuring measures, at the Third Plenary Session of the 14th Central Committee, a "Modern Enterprise System" was proposed as a corporate form compatible with the socialist market economy. This sets the "separation of bureaucracy and business" as a goal. Specifically, the *SOAE Law*, which governs the management of state-owned assets and deals with the rights and responsibilities of investors in relation to such assets, is based on the principle of the separation of government bodies and enterprises. Section 6 of the *SOAE Law* provides that the State Council and local governments shall perform investor functions, which separates the functions of the administration of public affairs from the functions of the state-owned assets investor and stipulates non-intervention in the legitimate and independent business operations of enterprises. Section 16 of the *SOAE Law* further provides that operational autonomy and other lawful rights and interests legally enjoyed by state-invested enterprises are protected by law.

For instance, the prospectus for the CNPC's issuance of short-term financing bonds[247] dated October 22, 2009 sets forth certain internal operational procedures and a description of the CNPC. Reading this in conjunction with the SOAE Law reveals

[247] Available online: http://app.finance. ifeng.com/data/stock/ggzw.php?id=13577821&symbol=601857, at 18-29.

that the CNPC is an independently operated corporation subject to state approval with respect to certain major corporate events, such as mergers, splits, an increase or reduction in registered capital, the issuance of bonds, distribution of profits, and dissolution, and petition for bankruptcy. Such practice is consistent with the legal requirements of the SOAE Law that SOEs operate independently from the government.

3.3.3 SASAC[248]

A. Overview

Before the SASAC was established in 2003, the rights of investors in SOEs were enjoyed by several Ministries or Commissions under the State Council. The Planning Commission had the authority to approve investment, the Economy and Trading Commission controlled operations, the Ministry of Finance had the right to transfer assets, and the Enterprise Working Commission controlled human resources. Due to the overlapping authority between these government agencies, SOEs often received various directions from the government.[249] The difficulty was that property rights, or who was the "investor," had not been properly identified. This was not simply a problem of tracing funds but of assigning property rights and liabilities, such that "the competing claimants — the various government departments and agencies often cannot reach consensus as to who is (or shall be) the "investor."[250]

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[248] The term of "SASAC" in this section of thesis refers to both the SASAC and its local authorities.

[249] *Supra* Note 27, at 77.

[250] See Harry G. Broadman, "The Business(es) of the Chinese State", the World Bank,

It was in these circumstances that the SASAC was set up to take on the responsibilities of investor and to supervise and manage the state-owned assets of enterprises (excluding the assets in the financial enterprises).[251] It shoulders the responsibility for "supervising the preservation and increment of the value of the state-owned assets" of the supervised enterprises.[252]

B. Investors in the two types of companies

(A) Non-listed holding companies

There are two types of non-listed holding companies in which the SASAC performs the role of investor: pure holding companies and mixed holding companies.

A holding company is said to be a "pure" holding company if it "exists solely for the purpose of owning stock in other companies" (exclusively having income deriving from participations in other companies).[253] If the holding company also engages in its own business for trading, operations, and manufacturing, it is said to be a "mixed" holding company.

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available at SSRN: http://ssrn.com/abstract=283959 or doi:10.2139/ssrn.283959, at 12.

[251] The flexibility is that "the State Council and the local people's governments may, when necessary, authorize other departments or bodies to perform the contributor's functions for state-invested enterprises on behalf of the corresponding people's government", as provided by Section 11 of by the *SOAE Law*.

[252] The "functions and responsibilities of SASAC are stated on the website of SASAC: http://www.sasac.gov.cn

[253] Alex Y. Seita & Jiro Tamura, "The Historical Background of Japan's Antimonopoly Law" (1994) U. Ill. L. Rev. 115, at 152-3; Novin Tabatabay & Kamen Troller, "Setting up a business in Switzerland", (1993) I.C.C.L.R. 4(9), at Supp i-viii.

a. Pure holding companies

Pure holding companies are usually the controlling shareholders of companies in two lines of businesses: the operation or investment of state assets. The subsidiaries of pure holding companies may engage in one or both types of business: operation focuses on the restructuring of insolvent (or near to insolvent) SOEs, and investment involves choosing good projects and portfolios for investment to make profit and increase the value of state assets.

Subsidiary SOEs are called state asset operating companies, or state asset investment companies, depending on their key business. For instance, the China Investment Corporation (CIC), established on 29 September, 2007 as one of the largest state asset investment companies in China, is engaged in equity investments overseas. The Central Huijin Investment Company, formerly the biggest financial investment company in China, was merged with the CIC group as one of its subsidiaries (although it has continued to carry out its role in China's domestic banking reform of capitalizing state-owned and -controlled banks and other financial institutions). The CIC invests in banks, trust companies, and fund management companies to gain financial returns.[254] The Shanghai state-owned Assets Operation Co., Ltd. (SHAOC) is a typical state assets operation company that was founded on October 15th, 1999. The SHAOC restructures assets by acquisition, management, or divestment. It strives to "provide services for the synergistic consolidation of SOEs

[254] Detailed information is available on the website of China Investment Corporation: http://www.china-inv.cn/cicen/

and the withdrawal of those state assets from non-strategic industries."[255]

b. Mixed holding companies

Mixed holding companies are usually a group of companies with a variety of subsidiaries in a chain of businesses in a specific industry involved with capital, technology, manufacturing, or marketing. Mixed holding companies are often the largest company in an industry on the national or local level. An example is the China National Tobacco Corporation,[256] which was previously a government agency that was transformed into an SOE.

Similarly, the China National Petroleum Corporation (CNPC), established on September 17, 1988 by the Ministry of Petroleum Industry, is China's largest oil and gas producer and supplier. The CNPC is a typical mixed holding company, with 161 directly-held subsidiaries and integrated businesses that cover "petroleum exploration and production, natural gas production and pipeline transportation, refining and marketing of crude oil and oil products, oilfield services, engineering construction, petroleum equipment manufacturing, as well as capital management, finance and insurance services."[257]

(B) Public listed companies

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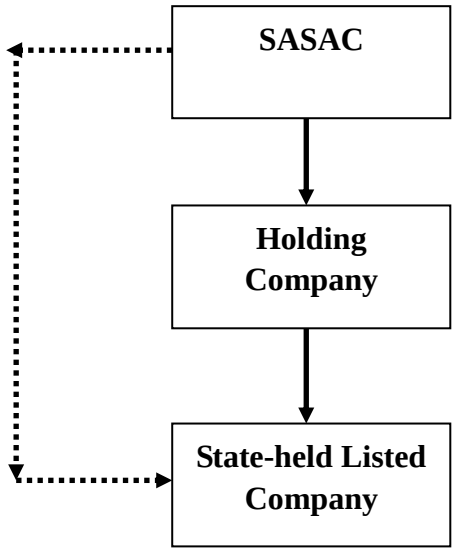
[255] See the website of Shanghai State-owned Assets Operation Co., Ltd.: http://222.66.64.132:8080/gzgs/english/gsjj-gsjs.jsp

[256] See more information from the website of China National Tobacco Corporation: http://www.tobacco.gov.cn/html/21/2107/210701.html

[257] See more information from the website of China National Petroleum Corporation: http://www.cnpc.com.cn

Since 2006, the SASAC has directly held shares in state-held listed companies, rather than being an investor in the non-listed holding companies.[258] The SASAC has announced that it will invest in more Chinese listed companies as the controlling shareholder from 2010.[259] Figure 3.2 demonstrates that the SASAC leapfrogs the non-listed holding companies to become the controlling shareholder of State-held listed companies.

Figure 3.2 Relationship between the SASAC and State-held Listed Companies



Taking out the holding companies in the middle will turn the three-level structure into a two-level structure. This two-level administration may help the SASAC to gain

[258] According to the report in the Shanghai Securities Newspaper, June 20, 2006, Shanghai Branch of SASAC would appear as the largest shareholder in the shareholder list of Shang Gang Group.

[259] It has been confirmed by Mr. Li Rongrong, Chairman of SASAC, at the 8th Corporate Governance Conference of China, held in Shanghai, on 18 December, 2009, available online: http://finance.qq.com/a/20091221/002933.htm

more direct access to the businesses of listed companies and reduce the costs incurred by having holding companies. Nevertheless, the existence of holding companies between the SASAC and listed companies may act as an "isolation strip" to separate bureaucracy from business in accordance with the principle of the separation of government bodies and enterprises enshrined in the *SOAE Law*. Furthermore, the "investor" role of the SASAC blurs the distinction between its functions of shareholder and regulator of state-held listed companies. In the event of shareholder lawsuits being filed by minority shareholders, whether legal proceedings would follow general commercial (corporate) or administrative legal procedures has not been clarified by any statute or regulation.

C. Investors' rights

As an investor in SOEs, the SASAC has two main supervising functions: regulation and control.

(A) Regulation

The SASAC drafts laws and regulations on the management of state-owned assets, and has established a series of rules to supervise the management of state-owned assets in respect of statistics, reporting, and evaluation.[260] State-held listed companies are required to report on operations, assets, market information, shareholdings, employees and other information to the SASAC within two working

[260] *Supra* Note 26, at 396.

days after their quarterly and annual reports have been disclosed to the public.[261]

(B) Control

a. Distribution control

The proceeds of investment are collected by the Ministry of Finance and monitored by the SASAC.[262] The proceeds consist of dividends; profits; income from the transfer of state assets or state-owned shares or from liquidation, and other proceeds.[263] Profits are calculated as 5% or 10% (in accordance with the industrial categorization declared by the SASAC and Ministry of Finance) of the net profits that are attributed to the ultimate holding company as reflected in the annual consolidated financial statements.[264]

b. Human resources control

The SASAC has the authority to appoint and dismiss directors, supervisors and senior executives ("top management") of non-listed holding companies.[265] The top management appointed by the SASAC would be punished should great losses of state assets or poor decision-making arise.[266] As the members of the top management team

[261] The *Notice of Establishing Information Reporting System concerning the Operations of State-held Listed Companies*, issued by the SASAC, with effect from 19 January, 2010.
[262] Art.5, the *Interim Measures for the Administration of the Collection of Proceeds from State-owned Capital of Central Enterprises*, issued by Ministry of Finance and SASAC, with effect from 11 December, 2007.
[263] *Ibid*. Art. 3.
[264] *Ibid*.
[265] Supra Note 241, Sec.22.
[266] *Supra* Note 18, at 21.

of holding companies are at the same time senior officials in the central government, it seems that such companies are more like an agency of the government, and in this case business has not practically been kept away from the bureaucracy.

The SASAC has no authority to directly appoint the top management in state-held listed companies (in which corporate governance is strictly regulated by corporate statutes and listing rules), but it can still control several aspects, including the nomination of top management, the procedures for general meetings and board meetings, and the determination of reserved matters to be approved by by special resolution, all of which can be set out by the corporate statutes without prejudice to the applicable laws.

c. Major events and financial control

The SASAC reviews the budgets and financial reports of SOEs, and monitors their business operations by annual and ad hoc auditing. It is also responsible for the approval of major events by the provisions in the constitutional documents of the listed company with respect to the investment, guarantee, restructure, pricing of transference of shares, and liquidation.[267] Directors appointed or nominated by the SASAC must report such major events to the SASAC. If SOEs lose their state-controlled status through restructuring or share transfer, then the SASAC must

[267] The transference of State-owned assets is usually through following ways: auction, gratuitous grant, agreement, or takeover in secondary market. However, there exist problems in this process. For example, what is the test to judge whether there is a loss of state assets if transferring; when the SASAC have the power to make approval, whether it is necessary to set up any other authorities to monitor the decision of the SASAC.

report the event to the State Council for final approval.[268]

In summary, the state-controlled model in China underpins both political control and SOE reform. SOE reform in China is connected with China's economic transition from a state-planned to a market-oriented economy, and local governments have taken on responsibility for the development of the local economy to further open up the Chinese economy to the outside world by the gradual and informal approach program of governmental decentralization and the privatization of SOEs.

[268] *Supra* Note 26, at 114.

Chapter IV Two-tier Shareholding Structure

"Every law has no atom of strength, as far as no public opinion supports it."

Wendell Phillips, American leader against slavery

4.1 Shareholding structure

4.1.1 Two types of ownership structure

As early as 1932, Berle and Means recognized the value of the "separation of ownership and control" in the corporate system and "a wider dispersion of stock ownership."[269] Jensen and Meckling (1976) support and develop the findings of Berle and Means.[270] However, La Porta *et al.* (1999) show that companies are typically controlled by families or the state.[271] Claessens *et al.* (1999) confirm that the family-control model is displayed in more than half of all East Asian corporations,[272] and Becht *et al.* (1999) also find an the extraordinarily high degree of concentration of shareholder voting power in Continental Europe compared with that in the United

[269] Berle, Adolf A. & Means, Gardner C., *The Modern Corporation and Private Property* (New York, Macmillan, 1932), at 47.

[270] See generally Michael Jensen & William Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3 J.Fin.Econ. 305.

[271] Through investigation of ownership structures of large corporations in 27 wealthy economies, it is found that relatively few of the subject firms are widely held except for those in economies with very good shareholder protection. Hence, the firms are typically controlled by families or the state. See *Supra* Note 269.

[272] The investigation of ultimate control patterns in 2980 publicly traded companies in nine East Asian economies (Hong Kong, Indonesia, Japan, Korea, Malaysia, the Philippines, Singapore, Taiwan and Thailand), it is concluded that large family control in more than half of East Asian corporations, and significant cross-country differences do exist. See See Stijn Claessens *et al*., "Who Controls East Asian Corporations?", Working Paper, 1999.

States and the United Kingdom.[273]

The corporate governance of public listed companies may differ due to different ownership structures, levels of board performance, and investor relations. It is recognized by Howson (2005) that the standard of good governance in a large public company with a diffuse shareholding population will be different from that of a closely held company. In the latter context, owners can negotiate the governance of the firm, or at least fully understand how the company is to be governed. In contrast, in widely held companies, public shareholders may "have no real expectation that their ownership interest will be coupled with a control right." Instead, their interest "may be limited by the circumstances to a purely economic interest to receive dividends or to be able to transfer the stock to capture accumulated value."[274]

A. Companies with a dispersed shareholding structure

This type of company is usually widely owned by a large number of shareholders, and is the traditionally prevailing corporate form in the United States and United

[273] The finding is the extraordinarily high degree of concentration of shareholder voting power in Continental Europe relative to the USA and the UK. See Becht, Marco & Röell, Ailsa, "Blockholdings in Europe: An International Comparison" (1999) 43 European Economic Review 1049.

[274] See generally Nicholas C. Howson, "Regulation of Companies with Publicly Listed Share Capital in the People's Republic of China" (2005) 38 Cornell Int'l L.J. 237, at 241.

Kingdom.[275] Here there is a separation of ownership and control that can create problems between shareholders and management. Strategies to overcome this are either to give more power to shareholders or to enhance the liability of directors.

B. Companies with a concentrated shareholding structure

This type of company is usually controlled by one or a few controlling shareholders. In a company with a concentrated shareholding structure, ownership and control are closely related, particularly in family-owned or state-held companies.[276]

Table 4.1 shows the ownership distribution of Chinese public listed companies between 1994 and 2005. It reveals that the aggregate ownership of the five top shareholders is mostly between 50 and 75 percent of the total, and accounts for the majority shareholding structure. The controlling shareholders are usually from among the top five shareholders.

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[275] See generally J. Armour, B.R. Cheffins & D. Skeel Jr., "Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom" (2002) 55 Vanderbilt Law Review 1699. See Fama, Eugene F. Fama & Jensen, Michael C., "Separation of Ownership and Control" (1983) 26 Journal of Law & Economics 301. See also *supra* Note 270. For ownership structure comparative research between the United States and United Kingdom, see Alan Dignam & Michael Galanis, "Corporate Governance And the Importance of Macroeconomic Context" (2008) 28 Oxford J. Legal Stud. 201; see also Brian R. Cheffins, "Law as Bedrock: The Foundations of An Economy Dominated by Widely Held Public Companies" (2003) 23 Oxford J. Legal Stud. 1.

[276] For comparative research between Germany and Canada, see Aviv Pichhadze, "Mergers, Acquisitions, and Controlling Shareholders: Canada and Germany Compared" (2003) 18 B.F.L.R. 341. For comparative research of listed companies between Germany and the United Kingdom, see Marc Goergen & Luc Renneboog, "Why Are the Levels of Control (So) Different in German and U.K. Companies? Evidence from Initial Public Offerings" (2003) 19 J.L. Econ. & Org. 141; see also Mahmut Yavasi, "Shareholding and Board Structures of German and UK Companies" (2001) 22(2) Comp. Law. 47. For China, see for example Pistor Katharina & Chenggang Xu "Governing Stock Markets in Transition Economies: Lessons from China" (2005) 7 Am. L. & Econ. Rev. 184.

Table 4.1 Ownership Distribution of the Five Top Shareholders of Chinese Public Listed Companies (1994－2005)[277]

Year	Total public listed companies for these statistics	Main five shareholders' ownership equals <=25/ as a percentage of the total	Main five shareholders' ownership equals >25 and <=50/ as a percentage of the total	Main five shareholders' ownership equals >50 and <=70/ as a percentage of the total	Main five shareholders' ownership equals >70/ as a percentage of the total
1994	168	7/4.16%	50/29.76%	74/44.05%	37/22.02%
1995	252	4/1.59%	75/29.76%	115/45.36%	58/23.02%
1996	512	10/2.00%	125/24.41%	260/50.78%	117/22.85%
1997	718	13/1.81%	179/24.93%	355/49.44%	171/23.82%
1998	825	13/1.58%	196/23.76%	402/48.73%	214/25.94%
1999	923	11/1.19%	212/22.97%	461/49.95%	239/25.89%
2000	1060	10/0.94%	251/23.68%	555/52.36%	244/23.02%
2001	1136	11/0.97%	282/24.82%	598/52.64%	245/21.57%
2002	1199	12/1.00%	293/24.44%	647/53.96%	247/20.60%
2003	1261	16/1.27%	303/24.03%	689/54.64%	253/20.06%
2004	1351	15/1.11%	310/22.95%	761/56.33%	265/19.62%
2005	1342	17/1.27%	353/26.30%	754/56.18%	218/16.24%

4.1.2 Two-tier shareholding structure

It should be noted that the economic implications of maintaining a concentrated shareholding by means of prohibiting the public trading of state-owned shares (before 2005) to a certain degree have shaped and reinforced the state-controlled model in its reliance on the financing functions of bank-based model, as banks still have a dominant role in the financing of public listed companies due to the restricted number of alternative funding channels by way of public trading.

[277] The statistics are from the CCER database ("*Zhong Guo Zheng Quan Shi Chang Shu Ju Xi Tong*"), which is jointly developed by Sinofin Information Services and China Center for Economic Research.

A. Nature of the two-tier shareholding structure

As at 31 December, 2009, there were a total of 1,718 Chinese public listed companies. The basic information on these public listed companies for the eight years ending 2009 is given in Table 4.2.

Table 4.2 Overview of Public Listed Companies in China

(A-share and B-Share, 2002－2009)[278]

Year	Total public listed companies	Total Shares (billion)	Tradable shares (billion)	Non-tradable shares (billion) / as % of total shares
2002	1224	587.55	203.68	383.87 65.33%
2003	1287	642.85	228.43	414.42 64.47%
2004	1377	714.94	260.65	454.29 63.54%
2005	1381	762.95	291.48	471.47 61.80%
2006	1434	1489.76	563.78	925.98 62.16%
2007	1550	2241.69	1033.15	1208.54 53.91%
2008	1625	2452.29	1257.89	1194.40 48.71%
2009	1718	2616.29	1975.95	640.34 24.48%

In China, public listed companies held by the state have a two-tier shareholding structure that divides shares into two categories: non-tradable shares and tradable shares. Non-tradable shares are usually composed of (1) state shares ("*Guojia Gu*"), which refer to shares owned by solely state-funded companies or SASAC, who are authorized by the central government or provincial governments to invest in Chinese

[278] The statistics are from the website of China Securities Regulatory Commission, available at: www.csrc.gov.cn

listed companies;[279] (2) legal person shares ("*Faren Gu*"), which are shares owned by a business enterprise and can be divided into the three categories of a. state-owned legal person shares ("*Guojia Faren Gu*"), which refer to shares held by state-owned enterprises (exclusive of solely state-funded companies);[280] b. social legal person shares ("*Shehui Faren Gu*"), which refer to shares owned by a domestic enterprise ("non-SOE enterprise"). Non-SOE enterprises fall outside of the definition of SOEs discussed in Section 3.2.1 of Chapter III;[281] and c. Foreign capital legal person shares ("*Waizi Faren Gu*"), which refer to shares held by foreign enterprises from overseas, Hong Kong, Macau, or Taiwan.[282]

There are three types of tradable shares: (1) A-shares, which are denominated in Yuan and only issued to domestic institutions or individual investors; (2) B-shares, which are only issued to foreign investors and are traded on the Chinese stock exchanges in foreign currency; and (3) H-shares, which are traded on the Hong Kong Stock exchange and do not fall within the scope of this research.

Table 4.2 shows that the majority of shares during the period 2002 to 2007 were non-tradable shares. The percentage of non-tradable shares has decreased since 2006 from 62.16% to 24.48% by the end of 2009, largely due to the Reform of Sales of Non-Tradable Shares of Public listed Companies in May 2005.

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[279] Article 2, *Provisions of Supreme People's Court on the Freezing and Auction of State-owned Shares of Listed Companies, issued by the Supreme People's Court*, with effect from 30 September, 2001.
[280] *Ibid.*
[281] *Ibid.*
[282] Annette Kleinbrod, *The Chinese Capital Market: Performance, Parameters for Further Evolution, and Implications for Development* (Wiesbaden: Deutscher Universitats-Verlag, 2006), at 85.

B. Three-phase development of a two-tier shareholding structure in state-held listed companies

(A) First stage (1957－1978): whole ownership and strict control over SOEs by governments

After the foundation of the People's Republic of China in 1949 and the series of socialization transformations in the following 8 years, a unitary administrative system based on a planned economy and a central authority was established in 1957. The state was not the ultimate owner, but rather the agent of the ultimate owner, which was Chinese citizens. However, this kind of ownership was too abstract to be exercised, so the state in the form of the central and local governments exercised ownership rights on behalf of the Chinese people, including the possession, us, and transfer of assets. No enterprise had a distinct legal personality, and thus the ownership of the assets of SOEs was attributed to the state and all profits were submitted to the state coffers. Employment and wages were also arranged by the state.

(B) Second stage (1978－1992): Autonomy for SOEs

After reform and opening up to the outside world in 1978, enterprises were given more freedom to manage their operation and distribute their profits, and productivity and efficiency substantially increased as a result. Despite the fact that it was required that government and enterprises should be separate, the government still had far-reaching bureaucratic control and influence over enterprises. Before the launch of SOE reform in 1978, the general manager and Party secretary ("*Dangwei Shuji*") were

parallel positions that constituted the top management of SOEs. The general manager was in charge of the business operations as the agent of government.[283] The Party secretary fulfilled the task of "supervising the implementation of the guiding principles and policies of the Communist Party"[284] in the enterprise. The general manager was either appointed by the government or was elected in a meeting of employee representatives. However, the manager elected in a meeting of employee representatives still had to be approved by the government.[285]All SOEs were assigned to be supervised by specific government agencies. [286] This sort of government-enterprise relationship arrangement promoted productivity to some extent and enhanced the efficiency of SOEs though the uniform distribution of resources between industries.

This process of granting autonomy to SOEs was principally carried in four phases[287]: (1)1978 - early 1980s, when the sources of liquid funds for SOEs were no longer grants from governments, but loans from banks;[288] (2) mid-1980s: previously, all of the profits of SOEs had to be submitted to the central government, but from this point 55% of profits had to be submitted as income tax, and the remainder were

[283] *Law of Industrial Enterprises Owned by the Whole People*, with effect from August 1, 1988, Sec.7.
[284] *Ibid*. Sec.8.
[285] *Ibid*. Sec 44.
[286] *Ibid*. Sec 56.
[287] For a detailed discussion of the four stages between 1978 and 1992 in the economic implications of reform in China, see generally Wei Chi & Yijiang Wang, "The 'Grabbing Hand' and Corporate Governance in China" in *Changing Corporate Governance Practices in China and Japan: Adaptations of Anglo-American Practices* (Edited by Masao Nakamura) (Palgrave Macmillan, 2008) 87-112.
[288] *Supra* Note 18, at 10-11. See also Peter Ho, *Institutions in Transition: Land Ownership, Property Rights, and Social Conflict in China* (Oxford University Press, 2005); Donald Clark, "What's Law Got To Do with It? Legal Institutions and Economic Reform in China" (1991) 10 UCLA Pac. Basin L.J. 1.

distributed between SOEs and the local government;[289] (3) late 1980s-1992: advent of the contract responsibility system between the government and SOEs (with distinct contract terms across industries and regions). This brought financial incentives to SOEs, because they submitted only a certain ratio of their profits and the wages of employees distributed by governments were related to the economic earnings accordingly;[290] (4) Post-1992: SOE managers were officially conferred by law autonomy over 14 areas of operation in their enterprises, including production, pricing, sales, procurement, foreign trade, investment, use of retained funds, disposal of assets, mergers, employment, and personnel.[291]

(C) Third Stage (1992－Present): the deepening SOE reform

a. Corporatization

The Shanghai and Shenzhen Stock Exchanges were opened in December 1990 and July 1991, respectively. In October 1992, the 14th Chinese Communist Party Convention ratified the establishment of a socialist market economy system, and launched reform to set up a "modern enterprise system" for the corporatization of SOEs starting in 1993. Four conditions had to be satisfied to establish a modern

[289] *Ibid*.

[290] *Provisional Regulation on the Contracting and Operational Mechanism of the Industrial Enterprises Owned by the Whole People*, promulgated by the State Council on February 1988. For empirical study of contract responsibility system, see generally Mary M. Shirley & Lixin Colin Xu, "Empirical Effects of Performance Contracts: Evidence from China" (2001) 17 J.L. Econ. & Org. 168; Mary M. Shirley & Lixin Colin Xu, "Information, Incentives, and Commitment: An Empirical Analysis of Contracts between Government and State Enterprises" (1998) 14 J.L. Econ. & Org. 358.

[291] *Regulation on Transforming the Management Mechanism of State-owned Industrial Enterprises*, promulgated by the State Council on July 1992.

enterprise system: (i) the clarification of property rights ("*Chanquan Mingxi*"); (ii) the clarification of rights and responsibilities ("*Quanze Mingque*"); (iii) the separation of bureaucracy and business ("*Zhengqi Fenkai*"); and (iv) scientific management ("*Guanli Kexue*").[292] The *Company Law* was promulgated in 1993, which laid the legal framework for a number of SOEs to be transformed into either limited liability companies or joint stock limited companies.[293]

b. "Grasping the large, releasing the small"

Since the mid-1990s, the strategy of SOE reform has changed from concentrating on every individual SOE to the whole economic system to achieve the sustainable development of SOEs. The policy of "grasping the large and releasing the small" was adopted and written into the Ninth Five Year Plan for 1996-2000.

"Grasping the large" means retaining large SOEs (500 to 1000 enterprises) in state ownership and making them conglomerates under the modern enterprise system.[294] "Releasing the small" means pushing the medium-sized and small SOEs to the market by listing on the stock exchanges or sale to private buyers.[295]

c. State-held listed companies

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[292] *Decision on Establishing Socialist Market Economy System*, passed by the Third Plenary Meeting of 14th Communist Party Session, November 1993.

[293] As at the end of 2007, around 63% of the Central SOEs (with the affiliates) have been corporatized, according to the statistics of SASAC. See *supra* note 26, at 26.

[294] Becky Chiu & Mervyn K. Lewis, *Reforming China's State-owned enterprises and banks* **(**Cheltenham, UK; Northampton, MA: Edward Elgar Pub., 2006), at 66.

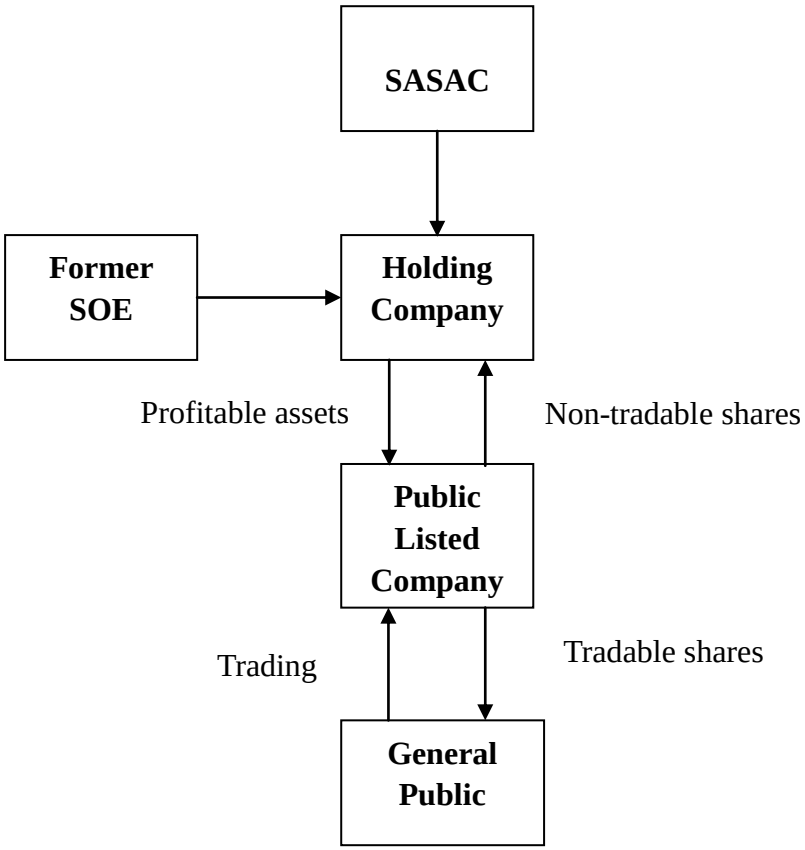
[295] *Ibid*. See also Julia Ya Qin, "WTO Regulation of Subsidies to State-owned Enterprises (SOEs)—A Critical Appraisal of the China Accession Protocol" (2004) 7 J. Int'l Econ. L. 863; Andrew Xuefeng Qian, "Riding Two Horses: Corporatizing Enterprises and the Emerging Securities Regulatory Regime in China" (1993) 12 UCLA Pac. Basin L.J. 62.

In 1999, SOE reform was directed toward adaptation to the economic system and growth, with the shareholding structures of many SOEs being changed to the state-held or state-participating (of which the state is not controlling shareholding) form.[296] The current Eleventh Five Year Plan from 2006 to 2010 sets out to facilitate the appropriate flow of market capital and drive state capital to key industries related to national security and economy lifelines.[297]

Figure 4.1 shows that during SOE reform, traditional SOEs have plucked out their profitable assets (which have been converted into non-tradable shares owned by the state) to incorporate new companies that are then listed on the stock exchanges, and the traditional SOEs have then become the holding company of the newly established listed companies. After listing, the remaining shares, which are bought by the general public, become tradable shares. This, in essence, is the operation of the two-tier shareholding structure with two categories of shares (tradable and non-tradable).

[296] *Decision of CPC Concerning SOE Reform and Development*, passed by the Fourth Plenum of the 15th Communist Party Central Committee on September 22, 1999.
[297] It was passed by the Fifth Plenum of the 16th Communist Party Central Committee on October 11, 2005.

Figure 4.1 Listing of State Assets in SOE Reform[298]



China is a socialist country with a principal ideology based on Communism since the last century that advocates public ownership rather than private ownership. The capital market was once regarded in China in the same manner as capitalism, and was rejected until Deng Xiaoping's Southern Speech in 1992. Since then, the role of the capital market has been positively acknowledged to serve as a platform for SOE reform through fund-raising and corporatization. Governments play a prominent role in this process. It is to ensure an economic system with public ownership as the

[298] Guy S. Liu & Pei Sun, "Ownership and Control of Chinese Public Corporations: A State-dominated Corporate Governance System" in Kevin Keasey, Steve Thompson & Mike Wright (edited) *Corporate Governance: Accountability, Enterprise and International Comparisons* (Hoboken, NJ: Wiley, 2005) 389, at 393.

principle that the shareholding structure of public listed companies is divided into tradable and non-tradable shares to give a two-tier market. This division is a result of mandatory regulation, rather than the free choice of the market.

4.2 One-tier shareholding: a more flexible shareholding structure－Reform of Sales of Non-Tradable Shares of Public Listed Companies (May 2005－Present)

4.2.1 Pre-reform

Under the two-tier shareholding structure,[299] there are three main differences between tradable and non-tradable shares. The first regards pricing, in that the price for non-tradable share is measured by the net assets of previous SOEs and other Chinese enterprises, whereas the issue price of shares tradable to the public is calculated following the market practice, and is usually higher than that of non-tradable shares. The second regards share transfers, in that the transfer of non-tradable shares requires a contract between seller and buyer. State-owned shares even require evaluation and approval by administrative procedures, whereas tradable shares can be freely transferred on the stock exchanges at trading prices set by the market. The third regards benefits. The benefits for holders of tradable shares are dividends and profits when they sell the shares, whereas shareholders of non-tradable shares are prohibited from transacting their shares on the stock exchanges, but usually

[299] It is also called as "split-equity structure" or "redesignation plan for domestic shares". See Sandra P. Kister, "China's Share-Structure Reform: An Opportunity to Move beyond Practical Solutions to Practical Problems" (2006) 45 Colum. J. Transnat'l L. 312, at 312; Paul B. McGuinness, "An Overview and Assessment of the Reform of the Non-Tradable Shares of Chinese State-owned Enterprise A-Share Issuers" (2009) 17(1) 41, at 44.

have controlling power over the company.

There are many disadvantages to the division of shares in this way. First, it causes conflicts of interest between shareholders of tradable and non-tradable shares, because the former focus more on the fluctuation of the share price, especially if they are short-term investors, whereas the latter take more care of the net asset value per share, because it is the responsibility of the holders of non-tradable shares from the government to ensure the value of assets without loss. The accretion of asset value depends mainly on profits.[300] Second, it is unfair to the holders of tradable shares, because this division gives one share a different price and different associated rights, which "distorts the stock market's pricing mechanism."[301] Third, it also creates a conflict of functions for the government as a market regulator and a large market participant. Fourth, it makes the abuse of power by controlling shareholders more possible by controlling the board of directors and board of supervisors, such as the infringement of minority shareholders' rights and of the assets of public listed companies by illegal related party transactions.

4.2.2 Process of reform

An initial pilot project to decrease the holding of state-owned shares[302] was carried out from September 1999 to December 2000. This experiment aimed to adjust

[300] Alexander Frednck, *Banking Financing & Accounting* (Lotus Press, 2005), at 58; See also Stavros A. Zenios, *Financial Optimization* (Cambridge University Press, 1996), at 149.
[301] *Supra* Note 299, at 323.
[302] This policy was brought forward on the fourth Plenary Meeting of 15th Communist Party Session, September 1999.

state-held listed companies without affecting the government's position of control. However, in the pilot companies, proposals were not tabled by public shareholders and the project had to be terminated. Later, in June 2001, a second pilot project was launched to raise funds for social insurance.[303] However, this was still not acceptable to public investors, and the experiment was again terminated. The failure of the second pilot project created panic in the capital market, which then experienced a four-year bear market until June 2005. As PRC Premier Wen Jiabao stated, "Lack of knowledge and imperfect market regulation have caused the bear market."[304] The failure of the pilot project to decrease the holding of state-owned shares was a result of the irrational valuation of state assets, which was based on the maintenance and increase of asset value and ignored the interests of holders of shares.[305] A pricing system following arms-length-transaction principles had not yet been set up.

In April 29, 2005, the Reform of Sales of Non-Tradable Shares of Public listed Companies in A share market was launched by the issuance of the "Notice of Sales of Non-Tradable Shares of Public listed Companies" by the China Securities Regulatory Commission (CSRC). Any public listed company that fulfils the requirements of the reform is conferred privileges by the CSRC in relation to application for re-financing.

Although many disputes have arisen since the launch of the reform, it is the Chinese government's firm resolution to promote a freer market economy through this

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[303] *Provisional Regulation Regarding Reduction of State-owned Shareholding for Raising Social Insurance Fund*, issued by the State Council, June 2001.

[304] Premier Wen Jiabao's speech, at the press meeting of the Third Annual Session of 10th National People's Congress, 14 March 2005.

[305] Zhang Shenhuai, *Legal Research of Controlling Power in the Chinese Listed Companies* (Law Press China, 2007) (in Chinese), at 143.

means. Learning from the failure of the pilot projects, the Chinese government is aware that an approval procedure is required, and thus any controlling shareholder of a state-held listed company is required to disclose the minimum stake percentage to be held after the completion of the transfer. This minimum stake percentage must be reported for examination and approval, especially in pivotal sectors and industries critical to the nation's security and interests.

Each public listed company must set out its own proposal in a "process of negotiation through which the non-tradable and tradable shareholders decide how much of a payment in shares the non-tradable shareholders must transfer to the tradable shareholders in order for their shares to gain liquidity in the market."[306] There is no uniform criterion for financing for companies. Instead, the proposal of each company requires board approval to convene a general meeting at which majority approval from holder of tradable and non-tradable shares must be obtained.

The legal nature of payment is still controversial. Some scholars think it should be regarded as consideration as a cost to gain the right for shares to be tradable. Others believe it should be restitution for the unjust enrichment of tradable shareholders that results from the overflow of benefits gained by non-tradable shareholders after they are allowed to sell their shares, because the original price of non-tradable shares is usually lower. Another point of view considers that the payment constitutes damages arising from breach of contract, because there is a statement in the prospectus and listing proclamation of all public listed companies that the shares

[306] *Supra* Note 299, at 332.

of promoters, that is, non-tradable shares, shall not be publicly tradable.[307]

There are commonly three types of proposals: (1) non-tradable shares are proportionately given to the holders of tradable shares free of charge; (2) holder of tradable shares can obtain an amount of cash paid by the holders of non-tradable share, who are not willing to lose control by giving up their shares; (3) the holders of tradable shares have the right to compensation for the difference when the share price falls to a stipulated point in the future. The pricing method of a proposal depends on the circumstances of the listed company in question.

When the proposal of a listed company is approved and completed, the originally non-tradable shares become "released shares," and are subject to trading restrictions for a period of 12 months. When this lock-up period expires, shareholders whose released shares account for no less than 5 percent of the total shares of the public listed company can sell no more than 5 percent of the shares owned in the next 12 months, and no more than 10 percent in the next 24 months.[308]

The transfer pricing of the state-owned shares of listed companies is based on the transaction price of the listed companies' shares in the securities market.[309] The

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[307] For the dispute of reform scheme, see generally Wu Xiaoqiu, *Capital Market in China after the Reform of Non-traded Shares* (People University of China, 2006) (in Chinese); Lv Hongbing & Li Kang, *Legal Issues of Non-traded Shares Reform: Perspective from Lawyers* (Law Press China, 2006) (in Chinese). See also He Ru, *Practice of Reform and Post-Reform of Non-trading Shares* (Hua Xia Press, 2006) (in Chinese); Fu Ziheng, *The topics on Non-trading Shares Reform* (Economic Management Press, 2006) (in Chinese).

[308] Art.3, *Guiding Opinions on the Listed Companies' Transfer of Original Shares Released from Trading Restrictions*, with effect from April, 2008.

[309] Art.6, *Interim Measures for the Administration of State-owned Shareholders' Transfer of Their Shares of Listed Companies*, issued by the State-owned Assets Supervision and Administration Commission of the State Council and the China Securities Regulatory Commission on 30 June 2007, with effect from 1 July 2007.

SASAC has the authority to examine and approve the transfer of state-owned shares.[310] If a share transfer is likely to have a significant influence on key national economic sectors, then the SASAC applies to the State Council for approval.[311]

4.2.3 Post-reform

As at 31 December 2009, around 476.78 billion shares (out of aggregated 626.37 billion non-tradable shares) had been released since the Reform in 2005.[312] A further 68.38% of the released shares have had their trading restrictions lifted, and 12.66% of these unrestricted released shares have been sold to the public.[313] The reform has made it possible to treat the holders of tradable and non-tradable shares equally and to further distribute the profits across all shareholders in public listed companies, but has also revolutionized China's stock market and raised fresh concerns over the reform of corporate governance in China.

While listed companies with non-tradable shares have been achieving the goal of their reform (the release of non-tradable shares and their further sale to the market), the listed companies, particularly former state-held listed companies, have also been undergoing transition from a state-concentrated shareholding structure to a more flexible structure of private ownership and a more diffuse ownership structure (a

[310] The income from transfer is required to place into the China's National Social Security Fund. See Paul B. McGuinness, "The Privatisation Process and Evolving Share Ownership Structure of Mainland China's Leading State Owned Enterprises" (2006) 14(1) Journal of Financial Regulation and Compliance 37, at 38.
[311] *Supra* Note 309, Art.7.
[312] The monthly statistics report (as at 31 December 2009), China Securities Depository and Clearing Corporation Limited, available at: http://www.chinaclear.cn
[313] *Ibid*.

dispersed shareholding structure with no controlling shareholder), although some are still controlled by the state.[314]

In general, the ultimate goal is to eliminate the division between tradable and non-tradable shares, and to form an integrated pricing system so that each shareholder can trade shares based on the market price. This means that shareholders will be concerned not only with net assets, but also with the positive cash flow and performance of companies in the market. In the long term, this should increase the confidence of investors, and improve corporate governance in listed companies.

The transacting of released shares is still subject to the approval of the SASAC, [315] but the more liquid capital market will probably create more opportunities for takeovers and will have a greater impact on the corporate governance of listed companies. Notably, when previously non-tradable shares are sold in the market, the stock price may fall as the supply exceeds demand, which will remain the same as before.[316]

This reform is an institutional arrangement for listing non-tradable shares in the A-share market, so it is "highly topical issue within the context of the Chinese equity

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[314] The tradability of the previous non-tradable shares does not mean that the state has to actually sell it shares. "The State can choose to remain in control just by not selling them." See Goergen, M., Manjon, M. & L. Renneboog, "Recent Developments in German Corporate Governance" (2008) 28 International Review of Law and Economics 175, at 191.

[315] *Supra* Note 309, Art. 8. It is required that "a shareholder owning or controlling no less than 5% of the shares of the listed company shall have the obligation of disclosure when selling the unrestricted released shares".

[316] *Supra* Note 307, at 115. The public shareholders shall have anticipated such losses from the falling share price, on the condition that the losses had been calculated into the pricing of proposal.

market."[317] It is expressly provided by the *Guiding Opinions on Share-trading Reform of Listed Companies*[318] that the reform of non-tradable shares is "a turning point to solve the issue of appropriation of the capital of listed companies and illegal related party transaction by controlling shareholders."[319] As the reform involves only the transfer of state-owned shares within the two-tier shareholding structure, it is perhaps "too early to gauge" the effectiveness of this reform "in resolving the milieu of problems that beset some of the SOEs,"[320] and whether tunneling by controlling shareholders (discussed below in 4.4.2 of this chapter) will be completely eliminated or whether controlling shareholders participate more positively in the governance and operation of the state-held listed companies.

4.3 Shareholders[321]

4.3.1 Three governance organs

There are three governance organs in a Chinese public listed company: the

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[317] *Supra* Note 299, *Paul B. McGuinness*, "An Overview and Assessment of the Reform of the Non-Tradable Shares of Chinese State-owned Enterprise A-Share Issuers" (2009) 17(1) 41, at 53.

[318] It is issued by the China Securities Regulatory Commission, State-owned Assets Supervision and Administration Commission, Ministry of Finance, People's Bank of China, and the Ministry of Commerce, on 23 August, 2005.

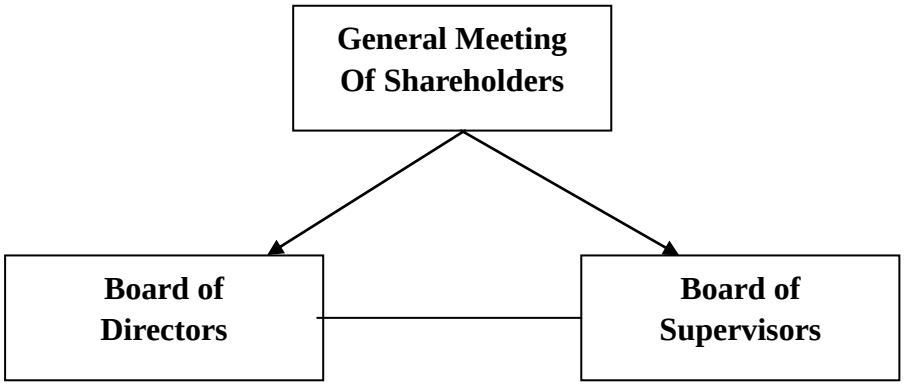
[319] Art.18, *Guiding Opinions of Share-trading Reform of Listed Companies*, issued by CSRC, SASAC, Ministry of Finance, People's Bank of China and Ministry of Commerce, with effect from 23 August, 2005.

[320] *Supra* Note 310, at 45.

[321] In some common law jurisdictions such as Singapore, UK, "member" rather than shareholder is used, specifically referring to those who subscribe to the memorandum and whose names are on the company register. That is to say, member is the legal shareholder, excluding beneficiary shareholder. In Chinese corporate context, there is no such distinction. "Shareholder" is the only legal term to be used, but the scope is similar to "member".

shareholder's general meeting, the board of directors, and the board of supervisors. The three organs are arranged in a triangular structure with the shareholder's general meeting at the top (see Figure 4.2). Corporate governance in China follows a two-tier board system in which the two boards function separately at the same level under the general meeting. Directors and supervisors (exclusive of employee representatives) are elected and removed at the general meeting.

Figure 4.2 Three Governance Organs



The distribution of power between the corporate organs is determined by law, the shareholders' subscription agreement or the company's articles of association,[322] depending on the doctrinal arrangement of shareholders and the board of directors, whether the contractual model, delegation model, or statutory model.[323]

The contractual model is reflected in the cases of *Automatic Self-Cleansing Filter Syndicate Co v. Cuninghame*[324] and *Quin & Axtens v. Salmon*,[325] in which the

[322] *Supra* Note 207, *Melvin Avon Eisenberg*, 1461, at 1461-2.
[323] Ross Grantham, "The Doctrinal Basis of the Rights of Company Shareholders" (1998) 57(3) Cambridge Law Journal 554, at 564-6.
[324] [1906] 2 Ch.34 CA. See also *Shaw & Sons (Salford) Ltd v. Shaw* [1935] 2 KB 113,

articles of association are held to be a contract under which shareholders have no authority over matters that have been assigned to the board of directors to manage. Under the model of delegation, the general meeting is the supreme organ of the company. The board of directors obtains its powers delegated from shareholders, who substantially control the board by amending the articles of association.[326] The statutory model involves statutory intervention in corporate governance. The rationale for this is first that the internal enabling rules for corporations to govern their power distribution may not be efficiently designed, and second that efficient rules that are adopted may be changed from time to time.[327] In modern corporate statutes in various jurisdictions, the board of directors is generally conferred management power, save for rights that are expressly attributed to shareholders by law or by the company's constitution.[328]

In the context of the three-organ corporate framework in China, power and authority follows a mixed model that contains the elements of contractual, statutory and delegation models. The powers of the three organs are mandated by law, and the articles of a company determine matters not expressly regulated by law. Public listed companies usually follow the draft articles contained in the *Articles Guidelines* when setting out their articles of association.

Corporations have multiple interacting and interlocking constituents, the interests

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CA; *Scott v. Scott* [1943] 1 All ER 582.

[325] [1909] 1 Ch. 311 CA.

[326] See the typical case of *Isle of Wight Railway v. Tahourdin* (1883) 25 Ch D 320, CA. See also *supra* 85, at 10 and 300.

[327] *Supra* Note 2, at 19-20.

[328] See for example Singapore *Companies Act* (Cap.50), Sec.157A.

of which either converge or diverge depending on the circumstances.[329] This requires an organizational arrangement that counterbalances the constituents and eliminates possibly abusive behavior. Accordingly, the general meeting has the right to approve decisions about fundamental corporate matters, the board of directors manages corporate operations, and the supervisory board monitors the business operations of the whole company.

4.3.2 General meeting

The shareholder's general meeting is termed the "company's supreme organ of authority"[330] in the *PRC Company Law*, which also determines how resolutions are passed at a general meeting. An ordinary resolution must receive more than half of the votes owned by all participating shareholders, whereas a special resolution must receive no less than two thirds.[331]

Election, dismissal, remuneration, and reports to be approved (typically annual financial budget plans, profit distribution plans, and loss recovery plans) of the directors and supervisors (excluding those who are e employee representative), and other ordinary matters related to corporate business and operations should be passed by ordinary resolution. Other fundamental matters, including the increment or reduction of share capital, the issuance of corporate bonds, assignment, division, change of business form, restructuring, winding-up, or the amendment of the

[329] *Supra* Note 207, *Melvin Avon Eisenberg*, at 1471-3;
[330] *Supra* Note 4, Sec. 99.
[331] The fundamental changes include mergers and acquisitions, addition or reduction of capital, provided by *PRC Company Law*, Sec.174, 176, 178 and 179.

constitutional documents of the company, require a special resolution to be passed.[332]

4.3.3 Role of shareholders

The nature of shares is summarized in *Borland's Trustee v. Steel Brothers & Co Ltd*. to consist of three components: interest, liability, and "a series of mutual covenants made by all the shareholders *inter se*."[333] The role of shareholder can take the form of owner, beneficiary, or guardian.[334] The "beneficiary" form, which is based on trust law, denies the shareholder discretional control over corporate business.[335] The "guardian" form gives the shareholder some specific and restricted functions as a watchdog to monitor management.[336]

The owner form consists of a mixture of rights, including possession, use, security, and transfer.[337] Shareholder "ownership" is based on the agency theory and the shareholder-centered view of the corporation,[338] which holds that the share is a

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[332] The general meeting has statutory right to decide the fundamental changes of the company. See *Russell v. Northern Bank Development Corp Ltd* [1992] 1 W.L.R.588. For the right to alter the articles, see *Allen v. Gold Reefs of West Africa Ltd* [1900] 1 Ch. 656; see also *Southern Foundries (1926) Ltd v. Shirlaw* [1940] A.C. 701.

[333] [1901] 1 Ch 279, at 288.

[334] See Jennifer Hill, "Vision and Revisions of the Shareholder" (2000) 48 American Journal of Comparative Law 39.

[335] *Ibid*. at 44-7.

[336] See generally Melvin A. Eisenberg, "The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking" (1969) 57 CAL.L.REV. 1. See also Peter V. Letsou, "Shareholder Voice and The Market for Corporate Control" (1992) 70 Wash. U. L.Q. 755; Jeffrey N. Gordon, "Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law" (1991) 60 U. CIN. L. REV. 347.

[15] See A.M. Honoré, Chapter V of "Ownership", in *Oxford Essays in Jurisprudence* (edited by Guest Anthony Gordon) (Oxford University Press, 1961) 107-47.

[338] *Supra* Note 323, at 554; *Supra* Note 334, at 42-4.

proprietary interest that justifies the shareholder's pursuit of profit maximization.[339]

Shareholders are usually categorized as the owners or "principals" of a company. They delegate their decision-making power to directors, who are their "agents." One assumption of this theory is that the goals of the principal and agent conflict.[340] The owners are referred to as "residual claimants" who bear "residual risk," or the "risk of the difference between stochastic inflows of resources and promised payments to residual claimants." As residual claimants, shareholders benefit themselves with whatever remains after the company has fulfilled its liabilities against its creditors.[341]

Agency problems arise from internal interactive relations between three actors—shareholders, the board of directors, and management —and the downward delegations of their respective functions and duties. This can be traced back to as early as 1776 in the "Wealth of Nations" by Adam Smith, who argues that the directors of a company are not likely to be as careful with other people's money as with their own.[342] The agency relationship based upon the separation of ownership and management is "a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves

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339 Masahiko Aoki, Gregory Jackson and Hideaki Miyajima (edited), *Corporate Governance in Japan: institutional change and organizational diversity* (Oxford University Press, 2007), at 18-9.

340 Solomon, Jill & Solomon, Aris, *Corporate Governance and Accountability*, (Chichester: Wiley, 2004) at17.

341 See Stout, L., "Bad and Not-so-bad Arguments for Shareholder Primacy" (2002) 75 Southern California Law Review 1189. See also Easterbrook, Frank H., *The Economic Structure of Corporate Law* **(**Harvard University Press, 1991).

342 See Letza, S., Sun, X. & Kirkbride, J., "Shareholding versus Stakeholding: A Critical Review of Corporate Governance" (2004) 12 Corporate Governance: An International Review 242. See also Barbara Cooper, *The ICSA Handbook of Good Boardroom Practice (2nd ed.)* (ICSA Publishing, 2006).

delegating some decision making authority to the agent."[343]

How to solve agency problems is an important issue in the survival of organizational forms.[344] The agency problem is controlled by decision systems that separate management (initiation and implementation) by agents from control (ratification and monitoring) by residual claimants.

A company is founded on a "nexus of contracts."[345] The company statutes usually "provide the terms of the contract by which shareholders purchase management's undivided loyalty to their welfare," where the key term is the management's fiduciary duty to operate the company for the maximization of shareholder wealth.[346] It is impossible to write "complete contracts"[347] for three reasons. First, it is difficult for people to think ahead and plan for all contingencies. Second, it is hard for the contracting parties to negotiate, especially when prior experience may not be a helpful guide. Third, it is difficult for plans to be written down in such a way that an outside authority, such as the court, will be able to interpret and enforce the contract.[348]

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[343] *Supra* Note 270, at 308. Jensen & Meckling (1976) identify that the agency costs are the sum of three components: "(1) the monitoring expenditures by the principle; (2) the bonding expenditures by the agent; (3) the residual loss resulting from the divergence in principal and agent's interests".

[344] Fama, Eugene, F. Fama & Jensen, Michael C., "Agency Problems and Residual Claims" (1983) 26 Journal of Law & Economics 327.

[345] *Supra* Note 270, at 311; Fama, Eugene F., "Agency Problems and the Theory of the Firm" (1980) 88 Journal of Political Economics 288, at 290.

[346] Millon, David, "Communitarians, Contractarians, and the Crisis in Corporate Law" (1993) 50 Wash & Lee L.Rev. 1373, at 1377-8.

[347] See *Supra* Note 3, *Shleifer, Andrei & Vishny, Rober*.

[348] See Hart, O. *Firms, Contracts, and Financial Structure* (Oxford: Clarendon Press, 1995), at 23.

4.3.4 Shareholders' ordinary rights

When the company is a going concern, every shareholder has participation rights and the right of access to corporate information.[349] When the general meeting demands a director, supervisor, or senior manager to sit in the meeting as a non-voting representative, then the appointed person must attend and should answer the queries of shareholders.[350]

A public listed company is also required to publicize its financial status, business operations, and material litigations, and must disclose its financial reports once every six months in each fiscal year.[351] Every shareholder is entitled to review the articles; the register of shareholders and corporate bonds; the minutes of the general meetings, board of directors meetings, and board of supervisors meeting; and the financial reports. Furthermore, detailed information on the candidates for directorships and supervisor positions must be disclosed to shareholders, including their personal particulars, relationship with the company or controlling shareholders, and shareholding in the company.[352]

The revised *Company Law* (2006) introduces the new requirement that the remuneration packages of directors, supervisors, and senior managers of a company must be regularly disclosed.[353] Following the revised *Company Law*, the CSRC now

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[349] *Supra* Note 4, Sec.98.
[350] *Ibid.* Sec. 151.
[351] *Ibid.* Sec.146.
[352] *Notice of the China Securities Regulatory Commission on Promulgating the Rules for the General Assemblies of Shareholders of Listed Companies*, No. 21 [2006], issued by the China Securities Regulatory Commission), with effect from March 16, 2006, Art.17.
[353] *Supra* Note 4, Sec.117.

requires remuneration to be disclosed in the annual reports of listed companies, including the earnings of each director, supervisor, and senior manager in terms of salary, bonuses, and allowances. Procedures and evaluations must also be disclosed. Any public listed company who disobeys this requirement must give an appropriate explanation to the CSRC in advance.

In reality, however, the remuneration of individuals are not disclosed in the annual reports of some large public listed companies,[354] and are instead replaced with the total amount earned by all of the directors, supervisors, and senior managers of the company. The explanation for this practice is that remuneration packages should be commercial secrets, as they are crucial to maintaining a company's human resources. Whether the CSRC finally approves this practice has not been publicly declared, but this explanation is not convincing. If remuneration should be confidential for large companies, then it should also be so for small and medium-sized companies.

4.3.5 Controlling shareholder

A. Overview

In Japan and Germany, ownership structure and voting rights may help to counteract the overwhelming power of controlling shareholders. In Japan, *Keiretsu*, or cross-shareholding, refers to a group of firms or financial intermediaries that own

[354] For example, China Vanke Co. Ltd. (listed on the Shen Zhen Stock Exchange since 1991) is one of the largest residential estate developing group in China; China Petroleum & Chemical Corporation (listed on the Shanghai Stock Exchange since 1991), is one of the largest integrated energy and chemical company in China.

stakes in each other.[355] Such bundling of equity effectively promotes some degree of integration, performs a monitoring role,[356] and prevents unexpected strategic corporate changes.[357] Most importantly, it makes it difficult for controllers to extract private benefits from control.[358] In Germany, big banks are both shareholders and creditors, and play an active part in corporate governance. Furthermore, they are involved in corporate management by voting rights deriving not only from their own held shares, but from those of other shareholders through proxy systems.[359]

The *PRC Company Law* defines the "controlling shareholder" as: (i) a shareholder whose stock occupies more than 50% of the total equity stock of a joint stock limited company; or (ii) a shareholder whose shareholding is less than 50% but is still larger than that of any other shareholder, so that the largest shareholder is still able to have a dominant influence over corporate matters.[360] That is to say, the

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[355] James McConvill, *Shareholder Participation and the Corporation: A Fresh Inter-disciplinary Approach in Happiness* (Routledge Cavendish, 2006), at 82.

[356] Michael Bradley, Cindy A. Schipani, Anant K. Sundaram & James P. Walsh, "Chapter 14: Corporate Governance at a Crossroads", in *Corporate Governance: An Asia-Pacific Critique* (edited by Low Chee Keong) (Hong Kong: Sweet & Maxwell Asia, 2002), at 455-6.

[357] *Supra* Note 339, at 8.

[358] Marco Pagano & Alisa Röell, "The Choice of Stock Ownership Structure: Agency Costs, Monitoring, and The Decision to Go Public" (1998) The Quarterly Journal of Economics 188, at 216.

[359] There are two typical rights for the holder of gold shares: "(i) fundamental decisions in relation to the corporate structure and management decisions of strategic importance; (ii) rights to influence the shareholder structure of the company". See Grundmann, Stefan & Möslein, Florian, "Golden Shares - State Control in Privatised Companies: Comparative Law" (April 2003). Available at SSRN: http://ssrn.com/abstract=410580 or doi:10.2139/ssrn.410580

[360] *Supra* Note 4, Sec. 217(2). This definition is similar to the stipulation of the American Law Institute: "(a) A 'controlling shareholder' means a person who either alone or pursuant to an arrangement or understanding with one or more other persons: (1)Owns and has the power to vote more than 50 percent of the outstanding voting equity securities of a corporation; or (2)Otherwise exercises a controlling influence

controlling shareholder is restricted by law to be the sole majority shareholder in the company.

Controlling shareholders normally control human resources, such as the appointment or removal of directors or senior executives, and decision-making over important matters in corporate operations, such as investment strategy or the distribution of dividends. According to a survey by the Shanghai Stock Exchange, the board chairman of 94% of the sample companies are majority shareholders,[361] and controlling shareholders have a crucial role in the investment strategy of 76% of the sample companies.[362]

The *CG Code* expressly provides that "the controlling shareholders shall nominate the candidates for directors and supervisors in strict compliance with the terms and procedures provided by law," [363] "the election of directors, supervisors,

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over the management or polices of the corporation or the transaction or conduct in question by virtue of the person's position as a shareholder". See American Law Institute, Principles of Corporate Governance: Analysis and Recommendations (St. Paul, Minn.: American Law Institute Publishers, 1994), §1.10; "Controlling shareholder" is not provided by the Listing Rules of Singapore Stock Exchange, in which "substantial shareholder" is instead defined as "a person who: (a) holds directly or indirectly 15% or more of the nominal amount of all voting shares in the company. The Exchange may determine that a person who satisfies this paragraph is not a controlling shareholder; or (b) in fact exercises control over a company". However, the minimum percentage of shareholding for controlling shareholders defined in the Listing Manual by Singapore Stock Exchange is 15%, which falls into the empirical range by the economists, that is, "the sum of a shareholder's direct and indirect voting rights exceeds an arbitrary cutoff value, which, alternatively, is 20 percent or 10 percent".

[361] Shanghai Stock Exchange, China Corporate Governance Report 2004: The Effectiveness and Independence of Board of Directors (Fu Dan University Press, 2004) (in Chinese), at 25-6.

[362] *Ibid.* at 31.

[363] *Supra* Note 10, Art.20.

senior executives or other personnel shall not be subject to the approval of the controlling shareholders," and "with respect to corporate operations, the controlling shareholders shall not directly or indirectly interfere with the company's decisions or business activities."[364] It may seem unnecessary to expressly provide these requirements in the *CG Code*, because such illegal behavior distinctly contravenes the *PRC Company Law* in respect of legal procedures regarding decision-making and personnel election,[365] but the *CG Code* aims to stipulate acceptable behavior by controlling shareholders in black and white.

B. Duty of controlling shareholder in China

The voting powers of shareholders should not be regarded as being fiduciary, like those of directors, to be exercised in the best interests of the company or any other shareholder.[366] "The starting point is the proposition that in general the right of a shareholder to vote his shares is a right of property which the shareholder is free to exercise in what he regards as his own best interests."[367] The majority rule allows majority shareholders to exercise their shareholding rights in their own interests, on the condition that the resolution of the majority "is not brought about by unfair or improper means, and is not illegal or fraudulent or oppressive towards those shareholders who oppose it."[368] A court would not be justified in intervening in a case

[364] *Ibid.* Art.21.
[365] *Supra* Note 4, Sec. 38 and 47.
[366] See *Pender v. Lushington* 6 Ch. D. 70 (M.R.1877); See also *supra* Note 85, at 487.
[367] *Re Astec (BSR) plc* [1998] 2 B.C.L.C. 556, at 584.
[368] *North-West Transportation Co Ltd v. Beatty* [1887] 12 App. Cas. 589, at 593. The majority rule is affirmed in this landmark case.

"merely because the minority alleged that the commercial judgment of the majority was wrong" or if "it was alleged that the majority had a personal interest in the subject-matter of the resolution."[369]

In the United Kingdom, for such equitable grounds to be secured, controlling shareholders are bound to act "bona fide for the benefit of the company as a whole" in cases of alteration of the company articles.[370] The US authorities recognized the fiduciary duties borne by controlling shareholders in *Southern Pacific Co. v. Bogert*[371] and *Wilkes v. Springside Nursing Home, Inc*.[372] In the latter case, the court considered it proper to "analyze the action of controlling shareholders in the particular case" and to ask whether they can "demonstrate a legitimate business purpose for their action."[373]

In China, the *CG Code* stipulates that controlling shareholders owe a "duty of good faith" toward "the listed company and other shareholders."[374] For example, controlling shareholders "are forbidden to engage in the same or similar competitive business as that of the listed company."[375] The question arises as to how the controlling shareholders of a public listed company can be prevented from

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[369] *Peters American Delicacy Co Ltd v. Heath* 61 C.L.R. 457, at 504.
[370] See *Allen v. Gold Reef of West Africa Ltd.* [1900] 1 Ch. 656 (CA).
[371] (1919) 250 U.S. 483, at 487-88. It is stated that "[T]he rule of corporation law and of equity invoked is well settled and has often been applied. The majority has the right to control; but when it does so, it occupies a fiduciary relation towards the minority, as much so as the corporation itself or its officers and directors. If through that control a sale of the corporate property is made and the property acquired by the majority, the minority may not be excluded from a fair participation in the fruits of the sale."
[372] 370 Mass. 842 (1976).
[373] *Ibid.* at 848. See also F. Hodge O'Neal, "Oppression of Minority Shareholders: Protecting Minority Rights" (1986) 35 Clev. St. L. Rev. 121, at 129.
[374] *Supra* Note 10, Art. 19.
[375] *Ibid.* Art. 27.

expropriating the interests of listed company or other shareholders by taking advantage of their privileged position to gain additional benefits. "Other shareholders' legal rights and interests" is ambiguous in legislation (literally, with reference to non-controlling shareholders), and whether the controlling shareholder in question breaches the duty of good faith is decided by the court depending on the facts and circumstances of each case.

4.4 Practical issues arising from state controlled ownership under the two-tier shareholding structure for state-held listed companies

Beyond the mandates of law, there are no identical corporate governance arrangements for public listed companies, because the relationships and interactions between and within shareholders, the board of directors, and the board of supervisors vary from company to company.

The securities market has its surges and failures, with expansion and recession of business cycles on a global basis. However, all countries have found that the securities market functions well if the regulatory framework is systemic and enforceable, and if investors are free to make rational choices.

In the past, the Chinese stock market was considered akin to a "slot machine" and the investors gamblers,[376] because there were no effective regulations and adjustments to catch up with the disorderly market.[377] After a nearly five-year

[376] See also Noëlle Trifiro, "China's Financial Reporting Standards: Will Corporate Governance Induce Compliance In Listed Companies?" (2007) 16 Tul. J. Int'l & Comp. L. 271, at 272.

[377] The report of Tomasic & Fu (2006) is based on an empirical study of corporate governance through interviews in China's top 100 public listed companies. It finds

contraction of the stock market from 2001 to mid 2005, the market experienced a boom from early 2006 until late 2008. During this period, the market share value of Chinese public listed companies increased by 10 times, boosted by the entrance of a number of blue-chip and red-chip stocks into the A-share market.[378] Since the reform of non-tradable shares in 2005, the whole stock market in China has made renewed progress, with the shareholding structure, investment products and transaction rules all improving.

There are two principal reasons why shareholders invest in the securities market. The first is the expectation of receiving share profits, or "cash flow rights," and the second is the expectation of being able to exercise control over assets, or "control rights."[379] Investors put corporate governance "on a par with financial indicators when evaluating investment decision." It has also been found that "an overwhelming majority of investors are prepared to pay a premium for companies exhibiting high governance standards. Premiums averaged 12-14% in North America and Western Europe; 20-25% in Asia and Latin America, and over 30% in Eastern Europe and Africa."[380] Strong protection for investors is associated with effective corporate

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that China's company and securities laws have not provided as strong legal protection of investors as might be expected by investors. See generally Tomasic Roman & Fu Jian, "Legal Regulation and Corporate Governance in China's Top 100 Listed Companies" (2006) 27(9) Company Lawyer 278.

[378] The source of news is from the website of Xin Hua Net, available at: http://news.xinhuanet.com/fortune/2007-11/19/content_7102654.htm

[379] Low Chee Keong, *Corporate Governance: An Asia-Pacific Critique* **(**Hong Kong: Sweet & Maxwell Asia, 2002), at 6.

[380] "Global Investor Opinion Survey: Key Findings" by McKinsey & Company in July 2002. 201 responses were received from professional investors from institutions with an estimated USD 9 trillion assets under management and covered 31 countries in Asia, Europe, Africa, Latin America, and North America, available at:

governance.[381] Protection for investors is thus the starting point for evaluating corporate governance.[382]

The controlling shareholder is the largest shareholder in the company and has ultimate control over corporate business.[383] In state-held listed companies, the state, as the holder of non-tradable shares comprising typically state-owned shares (state share and state-owned legal person shares, is the controlling shareholder.[384] The remaining shares of a company that are not owned by the controlling shareholder(s) are held by non-controlling shareholders. Thus, the holders of tradable shares in state-held listed companies are in effect minority shareholders.[385]

Local and central governments, who hold non-tradable shares on behalf of the state, have less incentive to ensure good corporate governance to protect minorities because non-tradable shares are not listed for public transaction, and any fluctuation in share prices has no direct financial impact on the government.

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http://www.mckinsey.com/clientservice/organizationleadership/service/corpgovernance/pdf/globalinvestoropinionsurvey2002.pdf

[381] La Porta *et al.* (2000) generalizes that "Recent research on corporate governance around the world has established a number of empirical regularities. Such diverse elements of countries' financial systems as the breadth and depth of their capital markets, the pace of new security issues, corporate ownership structures, dividend policies, and the efficiency of investment allocation." See La Porta Rafael, Lopez-de-Silanes Florencio, Shleifer Andrei & Vishny Robert W., "Investor Protection and Corporate Governance" (2000) 58 Journal of Financial Economics 3.

[382] *Ibid.*

[383] See the definition of controlling shareholder in Chapter I, *Supra* Note 24.

[384] See Table 1.2 in Chapter I.

[385] It is expressly stated by OECD that "in the state's interest to ensure that, in all enterprises where it has a stake, minority shareholders are treated equitably, since its reputation in this respect will influence its capacity of attracting outside funding and the valuation of the company. It should therefore ensure that other shareholders do not perceive the state as an opaque, unpredictable and unfair owner. The state should on the contrary establish itself as exemplary and follow best practices regarding the treatment of minority shareholders." See *Supra* Note 210, at 33.

Clearly, minority shareholders in state-held listed companies in China are not well protected under the two-tier shareholding structure where the state is controlling shareholder for several reasons. First, the interests of minority shareholders are infringed upon due to the tunneling behavior of the controlling shareholder. Second, minority shareholders may not be able to effectively exercise their rights to protect themselves under the cumulative voting system. Finally, minority shareholders may not able to effectively exercise their rights to protect themselves by derivative action.

4.4.1 Empirical study

Jensen and Meckling (1976)[386] and Shleifer and Vishny (1986)[387] revealed that the concentration of share ownership allows large investors to efficiently monitor management. However, a very strong ownership concentration may result in poor investor protection.[388] La Porta *et al.* give two reasons why ownership in countries with poor investor protection is more concentrated. First, large shareholders may need to own more capital to exercise control over a firm to avoid expropriation by the management. Second, due to poor protection, small investors may be unwilling to buy shares or may seek to buy them at low prices, which may indirectly result in

[386] *Supra* Note 270.
[387] See Shleifer, Andrei & Vishny, Robert W., "Large shareholders and Corporate Control" (1986) 94(3) Journal of Political Economy 461. The large shareholders in their sample are: families, pension and profit-sharing plans, and financial firms.
[388] La Porta et al. (1998) disclose that the concentration of ownership of shares in the largest public companies is negatively related to investor protections. See La Porta Rafael, Lopez-de-Silanes Florencio, Shleifer Andrei & Vishny Robert W., "Law and Finance" (1998) 106(6) Journal of Political Economy 1113.

ownership concentration.[389]

State controlled ownership through being the controlling shareholder in listed companies reflects that public authority over the private sector is a "legitimate private right under the market economy."[390] Empirical studies on the effect of state ownership on company performance have returned the contradictory findings that they either enhance or reduce firm performance.[391] Thus, when the controlling shareholder of a listed company is the state, the monitoring of management is not necessarily effective.[392] This criticism of state controlled ownership has two rationales. First, it is recognized that the state plays the dual roles of market regulator and player in commercial business, which often have conflicting functions.[393] Second, corporate costs increase when firms are used by politicians for political or social purposes,[394] because the government considers all of the social constituents of a firm and regards maximizing social welfare and stability as its primary goal.[395]

4.4.2 Infringement on the interests of minority shareholders due to tunneling by

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[389] *Ibid.*
[390] See *OECD Principles of Corporate Governance (2004)*, at 10.
[391] Mak Yuen Teen, "Ownership & Performance" (2005) Corporate Governance Executive, Vol. 3 Issue 1, Corporate Governance & Financial Reporting Centre of Business School, National University of Singapore, at 20 and 9.
[392] Zhang Zongxin & Sun Yewei, "The Optimization of Ownership Structure and Improvement of Corporate Governance of Listed Companies" (2001) 1 Economic Review 36 (in Chinese), at 37; See also Donald C. Clarke, "The Independent Director in Chinese Corporate Governance" (2006) 31 Delaware Journal of Corporate Law 125, at 141. It is recognized by Qian (1996) that political control could reduce agency problem; in other words, it may prevent managers from acting for their own interest at the expense of firm. Qian Yingyi, "Enterprise Reform in China: Agency Problems and Political Control" (1996) 4(2) Economics of transition 427.
[393] *Supra* Note 390.
[394] Supra Note 392, *Qian Yingyi*.
[395] *Supra* Note 391, at 8.

controlling shareholders

As has been stated, as part of SOE reform in China, traditional SOEs have extracted their profitable assets to incorporate new companies listed on the stock exchanges, and themselves have become the holding companies of these newly-established listed companies by holding non-tradable shares which are converted from the extracted assets. Economic conditions mean that these mixed holding companies are in great need of cash, because they must maintain their own business. This motivates them to tunnel assets from their listed subsidiaries to survive. Tunneling is defined by La Porta *et al.* (2000) as the transfer of assets and profits by controlling shareholders for their own benefit.[396] In China, there are two types of tunneling: illegal guarantees and the occupation of company funds.

A. Company guarantees

All corporate guarantees must be approved either by an ordinary resolution of shareholders at the general meeting or by two thirds of the directors (option selected by the company to be set out in the articles of association). Independent directors should issue independent comments on the guarantees in the company's annual report. In particular, material guarantees (where the guaranteed amount exceeds 30% of the company's total assets within a year) must be passed by special resolution at a general meeting.[397] Further, the *Securities Law* stipulates that public listed companies are

[396] See generally Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes, & Andrei Shleifer, "Tunneling", Harvard Institute of Economic Research, Discussion Paper, No. 1887.
[397] *Supra* Note 4, Sec. 122.

prohibited from providing guarantees to the controlling shareholder.[398] Further,

There are three problems with guarantees in China.

(i) The amounts guaranteed by many public listed companies (compared with the assets) exceed their own risk-bearing abilities. According to a survey of annual reports of all public listed companies in Shanghai conducted by the Shanghai Stock exchange in 2005, 54 companies guaranteed sums that exceeded 50% of their own net assets, and 15 companies guaranteed sums that exceeded 100%.[399]

(ii) Controlling shareholders seek indirect ways to acquire guarantees from public listed companies. For example, they may ask a listed company to provide guarantees to their subsidiaries or other related parties (which is not regulated by law).[400]

(iii) The chairman of the board of directors may have the power to influence decisions about guarantees. Table 4.3 shows that in 39.9% of state-held listed companies, the chairman of the board has the power to influence guarantee decisions. It is noteworthy that in 41.2% of the state-held listed companies in the Table the influential power is listed as being held by "others," reflecting that there may be more complicated factors involved in decision-making in those companies.

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[398] Supra Note 5, Sec. 60. See also *Regulation Regarding Fund Use between Listed Company And Related Party And Guarantee By Listed Company*, issued by the CSRC, (Zheng Jian Fa No.56), with effect from August 2003; *Regulation Regarding Guarantee by Listed Company*, issued by the CSRC (Zheng Jian Fa No.120), with effect from January 2006.

[399] *Supra* Note 18, at 75.

[400] *Ibid.*

Table 4.3 Survey of Influential Power over Guarantee Decisions in Companies Listed on the Shanghai Stock Exchange in 2006[401]

	Chairman	CEO	Financial controller	Controlling shareholder	Others
All sample	36.5%	4.0%	1.2%	13.0%	45.2%
State-held listed company	39.9%	4.7%	1.7%	12.4%	41.2%
Private listed company	27.8%	2.2%	0.0%	14.4%	55.6%

B. Occupation of company funds[402]

Table 4.4 shows that in the 147 sample listed companies, controlling shareholders occupied RMB 31.57 billion of company funds as at 30 June 2006. RMB 19.28 billion of the 88 state-held listed companies was held by holding companies, with an average of RMB 219.09 million being occupied for each state-held listed company. In accordance with the latest announcement by the CSRC, RMB 6.99 billion in 30 listed companies was still occupied by the controlling shareholders as at May 2008, and several companies had been disciplined by the CSRC and had been referred for criminal prosecution.[403]

Table 4.4 Occupation of the Funds of Public Listed Companies by the Controlling Shareholder (as at 30 June 2006)[404]

	Number	Percent (%)	Sum of occupation As at 30 June 2006 (billion, RMB)	Percent (%)
State-held	88	59.86%	19.28	61.06%

401 *Ibid*. at 74.
402 Fund occupation is normally an illegal act in that controlling shareholder's diversion of company's fund for his own use.
403 Available on the website of SASAC: http:www.sasac.gov.cn
404 *Supra* Note 18, at 76.

listed company				
Private listed company	59	40.14%	12.29	38.94%
Total	147	100%	31.57	100%

According to a survey by the SASAC, the occupation of funds by controlling shareholders occurs in 70% of listed companies that have suffered losses for two consecutive years.[405] In addition to internal governance problems in the listed companies themselves, such illegal activities are due to two external factors. First, SOE reform has failed to completely separate the holding company from the listed company, which may not be an actual separate entity. Second, the supervision of listed companies is so weak, and legal punishment insufficiently rigorous for such contraventions. For instance, it was publicized in the press that the chairman of a company listed on the Shenzhen Stock Exchange was fined just RMB 300,000 by the CSRC for allowing the occupation by the controlling shareholder of company funds of as much as RMB 2.5 billion (accounting for 96% of the company's net assets).[406]

C. Legal liability

There are three types of legal liability arising from tunneling.

a. Civil liability. The *Company Law* gives only general guidance that the "controlling shareholder should not take advantage of its relations with the

[405] Zhang Hong & Rong Hua, "The Necessity of Establishing Long-term Strategies to Abolish the Fund-occupation of Majority Shareholders of Listed Companies", 9 September 2008 (in Chinese), available at: http://www.sasac.gov.cn/n1180/n1271/n20515/n2697190/5490307.html

[406] *Ibid.*

subsidiaries to cause any loss or damages to the company or other shareholders." A controlling shareholder who has acted in contravention is liable to compensate for all losses and damages.[407]

b. Administrative discipline by the CSRC. This takes the form of (1) deprivation of qualification for fund-raising and the issuance of securities if the occupation action or illegal guarantee is not eliminated,[408] and (2) a warning or fine where disclosure is not made or falsely made.[409]

c. Criminal offences

Any director, supervisor, or senior executive who has breached his or her fiduciary duty and has caused the company to suffered great losses is guilty of an offence and is liable on conviction to a fine or imprisonment for a term not exceeding three years or both. If the company has suffered substantially great losses, then the conviction is a fine and imprisonment for between three and seven years.[410] However, exactly what constitute "great losses" and "substantially great losses" are interpreted by the courts, who also decide the amount of the fines.

These offences are also applicable to a controlling shareholder who has instructed a director, supervisor, or senior executive to carry out such offences. Where the controlling shareholder is not a natural person, for example a company, the

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[407] *Supra* Note 4, Sec. 21. See also *Regulation Regarding Fund Use Between Listed Company And Related Party And Guarantee By Listed Company*, issued by the CSRC (Zheng Jian Fa No.56), with effect from August 2003.

[408] *Regulation Regarding Protecting Rights and Benefits of Public Shareholders, issued by the CSRC*, with effect from December 2004.

[409] *Supra* Note 5, Sec.193.

[410] Sec.169, *Criminal Law* (revised 2006), promulgated on March 14, 1997, with effect from October, 1997

company is liable to a fine and the managers who directly participated in the offences will receive the same penalties as the director, supervisor, or senior executive in question.

D. In practice

In 2005, the CSRC issued the regulation "*Notice of Enhancing the Quality of Public listed Companies*," which requires the repayment of diverted funds by the end of 2006.[411] The repayment can be made in cash or through assets. Where the controlling shareholder does not have sufficient cash flow for repayment, the company can buy back the shares of controlling shareholders and cancel them. The novation of a company's loan liabilities to controlling shareholders is also allowed by the CSRC to solve the problem of outstanding funds that have been diverted by the controlling shareholder.

It is unsatisfactory that the CSRC officially controls these administrative disciplines to mitigate illegal fund diversion by controlling shareholders, rather than legally punishing them. Effectively, the controlling shareholder in question is not legally liable as long as it is able to repay by the due time. The government's concern for holding companies under the SOE reform is no justification for discharging the legal liabilities of the controlling shareholders in question by means of issuing regulations to demonstrate its legitimate appearance. In effect, the tunneling of

[411] *Notice of Enhancing the Quality of Listed Companies 2005*, issued by the CSRC, with effect from 2 November, 2005, issued by the CSRC and approved by the State Council.

controlling shareholders causes loss and damages to a company, and the interests of minority shareholders are infringed upon by such illegal activities. This is a case in which the rule of law is not genuinely and substantially pursued and enforced in China.

4.4.3 Inability of minority shareholders to effectively exercise their rights to protect themselves under the cumulative voting system

The OECD Principles of Corporate Governance 2004 state that all shareholders of the same class should be treated equally.[412] The *CG Code* emphasizes the protection of minority shareholders, while requiring that fair treatment be extended to all shareholders.[413] Given the disadvantageous position of minority shareholders in state-held listed companies due to their weak voting power and information asymmetry,[414] there are a few legal provisions specifically designed to protect minority rights (although these cannot go too far, otherwise the distinction between the small and large stakes of the company based on majority rules may disappear).[415]

The cumulative voting system was newly incorporated into the revised *Company*

[412] *Supra* Note 390, at 32.
[413] *Supra* Note 10, Art.2.
[414] Professor Robin Hollington explains the disadvantaged position of minority shareholders in his book that "the minority shareholder might conceivably be worse off in the long run by negotiating a customized agreement, because the mere fact that the parties have concluded, or have even just tried but failed to conclude, such an agreement may in certain circumstances be held to exclude any equitable constraints on the behavior of the majority, and the protection afforded by the agreement, *a fortiori* an unconcluded and therefore ineffective agreement, may be less than that which would have been afforded in equity". See Robin Hollington, *Shareholder' Rights* (Sweet & Maxwell, 2004) at 4.
[415] *Supra* Note 392, *Donald C. Clarke*, at 144-5.

Law in 2006. It basically means that when the shareholders' meeting elects directors or supervisors (exclusive of the supervisors who are employee representatives), it may adopt a cumulative voting system, as permitted by the articles of association or an ordinary resolution passed in a general meeting.[416] The *CG Code* requires that listed companies that are no less than 30% owned by controlling shareholders adopt a cumulative voting system, and stipulate the implementing rules for such a system in the articles of association.[417]

Cumulative voting system is a voting system under which a shareholder is allowed to multiply his or her voting rights by the number of nominees for the board of directors or supervisors so that he or she can focus on one particular seat and cast all of his or her votes for a single nominee of his or her choice. In contrast, in a regular voting system, shareholders cannot cast more than one vote per share to any single nominee. The process of cumulative voting is thought to provide minority shareholders (investors who control fewer votes) with the ability to "exert a considerable amount of influence" on the outcome of elections.[418]

Cumulating voting is optional, and thus companies may choose not to implement it (unless otherwise required by law). Nevertheless, increasing numbers of public listed companies in China are adopting cumulative voting, probably to demonstrate their willingness to keep up with best practice in corporate governance to attract

[416] *Supra* Note 4, Sec.106.
[417] *Supra* Note 10, Art.31.
[418] Frank H. Easterbrook & Daniel R. Fischel, "Voting in Corporate Law," (1983) 26 J. Law & Econ. 395.

public investors.[419] This has positive significance for the recognition of the cumulative voting system by legal rules, but its implementation is inevitably subject to various external factors, such as the controlling shareholder's interests. Two problems are encountered in practice that prevents minority shareholders in state-held listed companies from effectively exercising their rights to protect themselves.

(A) Nomination is still under the control of controlling shareholders

a. Who has the right to nominate?

The *PRC Company Law* is silent on the nomination of the board. It is thus generally regulated by the articles of association of each company. However, there are still two ways to nominate the non-independent directors under the *PRC Company Law*: first, shareholder(s) that separately or aggregately hold no less than 10% of the company shares have the right to request the board to convene a extraordinary general meeting (EGM)[420] to nominate non-independent directors; second, no less than ten days before the date of the shareholders' meeting, shareholders separately or aggregately holding no less than 3% of the company shares have the right to make a nomination proposal to the board, which will then submit to the general meeting for resolution.[421] In particular, to nominate independent directors, the *ID Guideline* provides that the board of directors, supervisory board and shareholders who hold

[419] Li Xiang, "Cumulative Voting: Dilemma and Solutions" (2006) 73 Financial Law Reform 23 (in Chinese), at 35.
[420] *Supra* Note 4, Sec. 101.
[421] *Supra* Note 4, Sec. 103.

more than 1% of the shares has the rights to nominate.[422]

b. Empirical evidence[423]

Table 4.5 shows that listed companies in which the top six to ten shareholders own not less than 3% of shares constitute less than 10% of the total listed companies in China. Table 4.6 shows that of the shareholders owning tradable shares, the companies whose top two to top seven shareholders own not less than 3% of shares account for the highest (2.31%) and the lowest (0.07%) of the total in the years from 2003 to 2005, demonstrating a very low percentage of 3% shareholding among general public shareholders. Thus, even if the top 10 shareholders' ownership could be aggregated (Table 4.7), there would still be less than 50% of public listed companies in which the top ten shareholders as parties in concert would be entitled to nominate candidates.

It is common practice in Chinese state-held listed companies that the candidates are pre-determined by the controlling shareholders, taking into account the view of the top 5-10 shareholders. The proposition of the candidates is then submitted for approval to the board of directors, which convenes a general meeting to pass the resolution.[424] Thus, candidates are mostly still nominated by the controlling

[422] Supra Note 11, Art.4(1).

[423] The Table 4.5, Table 4.6, and Table 4.7 adopt the same statistical model as that in Ning Xiangdong, *Corporate Governance Theory and Cases* (China Development Press, 2006) (in Chinese), at 351, which is based on the year of 2004. In addition, I make a more systematical calculation for the period of 6 years from 2000 to 2005 (the statistics is extracted from CCER database developed by Sinofin Information Services and China Center for Economic Research, *supra* Note 129.

[424] Zhang Mingyuan, "Legal Issues of Cumulative Voting system", Shanghai

shareholders, who have a distinct advantage over minority shareholders due to their statutory rights to propose candidates (threshold of 3%)[425] and to request the board to convene an EGM (threshold of 10%).[426]

Securities Daily (in Chinese), 6 April 2004.

[425] *Supra* Note 4, Sec.103.

[426] *Ibid*.

Table 4.5 Top 10 shareholders owning not less than 3% of shares (2000-2005)

Year	Listed Companies	1	2	3	4	5	6	7	8	9	10
2000	1060	1059	654	383	223	108	43	18	4	4	1
2001	1136	1135	707	428	229	114	40	11	5	2	2
2002	1200	1199	779	475	266	127	46	13	3	2	2
2003	1266	1260	845	536	297	141	54	21	8	4	6
2004	1354	1351	927	591	335	164	68	25	11	3	13
2005	1343	1342	939	598	329	155	68	24	5	3	3
Year	Listed Companies	1	2	3	4	5	6	7	8	9	10
2000	1060	99.91%	61.70%	36.13%	21.04%	10.19%	4.06%	1.70%	0.38%	0.38%	0.09%
2001	1136	99.91%	62.24%	37.68%	20.16%	10.04%	3.52%	0.97%	0.44%	0.18%	0.18%
2002	1200	99.92%	64.92%	39.58%	22.17%	10.58%	3.83%	1.08%	0.25%	0.17%	0.17%
2003	1266	99.53%	66.75%	42.34%	23.46%	11.14%	4.27%	1.66%	0.63%	0.32%	0.47%
2004	1354	99.78%	68.46%	43.65%	24.74%	12.11%	5.02%	1.85%	0.81%	0.22%	0.96%
2005	1343	99.93%	69.92%	44.53%	24.50%	11.54%	5.06%	1.79%	0.37%	0.22%	0.22%

Table 4.6 Top 10 shareholders (tradable shares) owning not less than 3% of shares (2003-2005)
(Before 2002, there were no general public shareholders owning not less than 3% of shares)

Year	Listed company	1	2	3	4	5	6	7	8	9	10
2003	1266	133	21	5	3	2	1	0	0	0	0
2004	1354	127	22	5	2	2	1	1	0	0	0
2005	1343	175	31	8	3	2	0	0	0	0	0
Year	Listed	1	2	3	4	5	6	7	8	9	10

	company										
2003	1266	10.51 %	1.66%	0.39%	0.24%	0.16%	0.08%	0	0	0	0
2004	1354	9.38%	1.62%	0.37%	0.15%	0.15%	0.07%	0.07%	0	0	0
2005	1343	13.03 %	2.31%	0.60%	0.22%	0.15%	0	0	0	0	0

Table 4.7 Aggregated Top 10 shareholders (tradable shares) owning not less than 3% of shares (2003-2005)

Year	Listed company	1-2	1-3	1-4	1-5	1-6	1-7	1-8	1-9	1-10
2003	1266	202	246	272	301	327	346	362	401	424
2004	1354	264	327	358	385	395	412	429	464	481
2005	1343	317	377	432	457	485	504	528	582	600
Year	Listed company	1-2	1-3	1-4	1-5	1-6	1-7	1-8	1-9	1-10
2003	1266	15.96%	19.43%	21.48%	23.78%	25.83%	27.33%	28.59%	31.67%	33.49%
2004	1354	19.50%	24.15%	26.44%	28.43%	29.17%	30.43%	31.68%	34.27%	35.52%
2005	1343	23.60%	28.07%	32.17%	34.03%	36.11%	37.53%	39.31%	43.34%	44.68%

(B) Do minority shareholders have enough votes for their candidates?

The formula to determine the number of shares necessary to elect a given number of directors is

$$X = (Y * N1) / (N2 + 1) + 1,$$[427]

where X = the number of shares needed to elect a given number of directors,

Y = the total number of shares at the general meeting,

N1 = the number of directors one desires to elect, and

N2 = the total number of directors to be elected.

In the formulation, the variable N2 is inversely proportional to X, which means that the fewer the total number of directors to be elected, the greater the number of shares minority shareholders need to own. The number of directors and proportion of independent directors are provided by the corporate laws and regulations (discussed in Chapter V).

What is noteworthy is that the variable N1 is directly proportional to X. For example, if an election is for 5 directors, the company has 1000 shares (with one vote per share, 800 shares owned by one controlling shareholder, and 200 shares owned by minority shareholders), and all of the shareholders have attended the general meeting, then, under the cumulative voting system, the number of shares that minority shareholders need to elect one director is:

$X = (1000*1)/(5+1)+1 = 167.66.$

The number of shares needed by minority shareholders to elect two directors is:

$X = (1000*2)/(5+1)+1 = 334.33.$

The number of shares needed by minority shareholders to elect three directors is:

[427] The formulation is a research finding by Charles Marvin Williams, "Cumulative Voting for Directors", published in 1951, Graduate School of Business Administration, Harvard University.

X = (1000*3)/(5+1)+1 = 501.

Thus, when minority shareholders wish to elect more candidates, they need more shares for the election. If minority shareholders hold a very small number of shares compared with the total number of company shares, then it is difficult for them to elect their directors. In the foregoing case, minority shareholders who hold 200 shares of the company are able to elect just one director.

4.4.4 Inability of minority shareholders to effectively exercise their rights to protect themselves by derivative action

A. Common law

The fundamental rule in *Foss v Harbottle*[428] is that the company is the proper plaintiff in an action in respect of a wrong done to a company. If the wrong is ratifiable by a simple majority of the resolution in a general meeting, then no individual shareholder may bring an action.[429] Jenkins LJ explains in *Edwards v. Halliwell* when this rule does not apply: (1) "if the alleged wrong is *ultra vires* the corporation because the majority of members cannot confirm the transaction;" (2) "if the transaction complained of could be validly done or sanctioned only by a special resolution or the like, because a simple majority cannot confirm a transaction which requires the concurrence of a greater majority."[430]

The only exception to the rule from the case of *Foss v Harbottle* is "where the

[428] (1843) 2 Hare 461, 67 ER 189.

[429] Professor Robin Hollington illuminates two fundamental objections to a derivative action in his book *Shareholders' Rights* (Sweet & Maxwell, 2004): "(a) the action is not duly authorized by the proper organs of the company; it is as if individual A was bringing an action for the benefit of individual B without B's consent; (b) the minority is seeking to escape from the principle of majority rule".

[430] [1952] 2 All ER 1064.

wrong amounts to a 'fraud' and wrongdoers are in control of the company."[431] The ability of a shareholder to file a lawsuit must be decided as a preliminary matter before the trial. The "fraud" must be understood in its "wide sense" as comprising not only fraud at common law but also fraud in the wider equitable sense of that term, as in the equitable concept of fraud in terms of power. This involves with the "use of directors' powers intentionally or unintentionally, fraudulently or negligently, in a manner which benefits themselves at the expense of the company. It does not require ownership of controlling state of the company. It is sufficient that the person together with other people can get a majority of the company."[432]

B. Statutory derivative action

(A) Singapore

Pursuant to the Singapore *Companies Act*, a shareholder may seek court relief where[433] (a) the company's affairs are being conducted; and (b) the director's powers are being exercised in one of the following four ways: "(i) in an oppressive manner vis-à-vis the member(s); (ii) in disregard to the member(s)' interests as member(s); (iii) unfairly discriminates against members, or (iv) is prejudicial to members."[434] The court may accordingly make a variety of orders, among which minority shareholders may be authorized to file the derivative actions in the name of or on behalf of the company.[435]

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[431] *Ibid.*
[432] *Ibid.*
[433] *Supra* Note 328, Sec. 216(1).
[434] In the case of *Over & Over Ltd v. Bonvests Holdings Ltd. and Another* [2008] SGHC 226, the High Court is of the opinion that "there was no meaningful distinction between all four limbs in s.216"; "[R]ather than distinguishing one ground from the other in Sec.216, the four grounds ought to be considered as a compound one". The Court has observed that "the touchstone in any oppression action is fairness".
[435] *Supra* Note 328, Sec. 216(2). In the UK, the personal remedy for an aggrieved

The statutory derivative action is provided for by Section 216A of the Singapore *Companies Act* on the three conditions that "(i) the complainant has given 14 days' notice to the directors of the company of his intention to apply to the Court if the directors of the company do not bring, diligently prosecute or defend or discontinue the action; (ii) the complainant is acting in good faith; and (iii) it appears to be prima facie in the interests of the company that the action be brought, prosecuted, defended or discontinued."[436] However, this provision is not applicable to public listed companies.

(B) The UK

The "derivative claim" under the UK *Companies Act* 2006 has two elements: "(i) in respect of a cause of action vested in the company, and (ii) seeking relief on behalf of the company."[437] The cause of action arises from "an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company."[438] In particular, Section 369 to Section 373 of the UK *Companies Act* 2006 provides statutory remedies in the specific case of "unauthorized donations

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shareholder based on "unfair prejudice" is provided by Section 459(1) of the UK *Companies Act* 1985.[435] It was common for judges to ask whether the majority had infringed the "legitimate expectations" of the minority in spite of their "extraneous equitable considerations and constrains". Such expectations are "what the shareholder initially bargained for", as stated by Lord Wilberforce that "a visible departure from the standards of fair dealing and a violation of the conditions of fair play on which every shareholder who entrusts his money to a company is entitled to rely". See *Re Kong Thai Sawmills* [1978] 2 MLJ 227, at 227. In the case of *O'Neil v. Phillips* [1999] 1 WLR 1092, Lord Hoffman deviates from the use of "legitimate expectation"; instead, the equitable principles would be adopted: "equitable considerations make it unfair for those conducting the affairs of the company to reply upon their strict legal powers", so "unfairness may consist in a breach of the rules or in using the rules in a manner which equity would regard as contrary to good faith".

[436] *Supra* Note 328, Sec. 216A(3). For Singapore statutory derivative action, see also Pearlie Koh Ming Choo, "The Statutory Derivative Action in Singapore – A Critical and Comparative Examination" (2001) 13 Bond Law Review 64, at 86.

[437] *Supra* Note 118, Sec. 260(1).

[438] *Ibid.* Sec. 260(2).

and expenditures."[439]

C. China

(A) Legislation

Before the *Company Law* was revised in 2006, there were no express provisions in the 1993 *Company Law* and sectoral regulations concerning the shareholder's derivative claims against the offending corporate personnel. For the first time, Section 152 of the revised *PRC Company Law* in 2006 provides the derivative claim as follows.

a. Defendant

The defendant in a derivative suit covers not only directors, senior executives, and supervisors, but also any person who has caused the company's loss. The law does not specify that controlling shareholders must be the defendant, but when the controlling shareholder in question has met the requirements for cause of action, he or she may be sanctioned under Section 152 of the *Company Law*.[440]

b. Plaintiff

[439] Sec. 369(1) of UK *Companies Act* 2006 provides that it "applies where a company has made a political donation or incurred political expenditure without the authorization required". Section 369(3) requires that the directors in default shall fall in either of the two scenarios: "(1) the directors shall be those who, at the time the unauthorized donation was made or the unauthorized expenditure was incurred, were directors of the company by which the donation was made or the expenditure was incurred"; or (2) the directors shall be "the directors of the relevant holding company where (i) that company was a subsidiary of a relevant holding company, and (ii) the directors of the relevant holding company failed to take all reasonable steps to prevent the donation being made or the expenditure being incurred".

[440] Xiao Huang, "Shareholders Revolt: The Statutory Derivative Action in China" CLPE Research Paper 49/2009, Vol.05 No.09, available at: http://ssrn.com/abstract=1516448, at 7.

To be a proper plaintiff, shareholders should separately or aggregately hold no less than 1% of the total shares of a company for a period of at least 180 consecutive days on or before the damage or loss to the company is caused.[441] The threshold of 1% is to prevent minority shareholders from abusing the right of appeal so that the normal operations of the company are not affected. The 180-day rule aims to prevent people from intentionally buying shares for speculative profit-making through litigation after learning that the company's interests have been infringed.[442]

c. Procedure

Before a derivative claim is filed, shareholders must ask the board of supervisors in writing to initiate a lawsuit; if any supervisor is the person who has caused the company's losses, shareholders shall write to the board of directors alternatively.[443] If the board fails to do so within 30 days of the date of receiving the request, then the

[441] Art.4, *Provisions on Several Issues Concerning the Application of the PRC Company Law* (Interpretations of *PRC Company Law*), issued by the Supreme People's Court on 28 April 2006, with effect from 9 May 2006.

[442] The scope of plaintiff for legal proceedings is narrower than the counterpart of Singapore. For personal remedy under Section 216 of *Companies Act* of Singapore, any member or holder of a debenture of a company could be a complainant. For derivative action under Section 216A, the court has greater discretion: in addition to the company member, "any other person who, in the discretion of the Court, is a proper person to make an application". In common law, the plaintiff may not be a member of the company at the time of alleged wrong; but he must be a member at the time of bringing the action. See the classic case *Seaton v. Grant* (1867) LR 2 Ch App.459. In that case, the plaintiff sustained a great loss by speculating in the company shares. And then he purchased five shares and filed the suit. As stated by Sir G. J. Turner, LJ, "although I by no means approve of such conduct, yet I cannot venture to say that for this reason the Court ought to interfere upon motion to deprive a Plaintiff of his rights, if, upon the hearing, he should appear to be entitled to anything."

[443] See for example *Hao Ling v. Wang Jiyan*, decided by Beijing No,1 Intermediate Court (2009) No.5142. In this case, the plaintiff is both the shareholder and supervisor of the company. She filed the derivative claim as shareholder against the executive director of the company. The Court takes the position that the internal remedy procedure has been exhausted because the plaintiff is herself supervisor of the company.

shareholders can proceed to derivative action.[444] The pre-suit procedural requirement "provides companies with the opportunity to exhaust internal remedies first and to involve centralized management in the decision of whether to sue or not."[445]

The exception to this rule is that in emergency situations, failure to file an immediate claim may cause unrecoverable damages to the company, and thus proper shareholder(s) can, on their own behalf, directly file a lawsuit to the court instead of asking the board of directors or board of supervisors in advance.[446]

d. Cause of action

There are two elements of cause of action. The first is that the defendant has contravened corporate law or the constitutions of the company, and the second is when such contravention has caused loss or damage to the company. The intentions and knowledge (for example, whether the defendant acted in good faith in the interests of the company) of the accused are not reviewed by the courts.

(B) Judicial application

a. From rejection to acceptance

Since the establishment of the stock exchanges in 1992, the law has remained silent in relation to derivative claims, despite the fact that "disputes between controlling shareholders and minority shareholders have not been uncommon in China."[447] Although a number of directors, supervisors and top executives have received administrative disciplines from the CSRC or been referred for criminal

[444] See for example *Zhou Yuchao v. Zhao Yu*, decided by Foshan Intermediate Court of Guangdong Province (2007) No.348.
[445] *Supra* Note 440, at 9.
[446] See for example *Xu Wenxing and others v. Wu Yongjian*, decided by Beijing No.2 Intermediate Court (2009) No.11811.
[447] *Supra* Note 440, at 11.

prosecution, "the injured shareholders have been left without proper remedies" by law.[448]

The Chinese courts tend to refuse to hear such cases because minority shareholders are "unsuitable" to be the plaintiff. For instance, Chengdu Hong Guang Company Limited (which was the first listed company to commit the criminal offence of "fraudulent financial reporting" and was finally delisted) was punished by the CSRC in 1998 for illegal transactions, and Henan Lian Hua Monosodium Glutamate Ltd. ("*Lian Hua Wei Jing*", listed on the Shanghai Stock Exchange) was punished by the CSRC for expropriation by controlling shareholders, yet the courts refused to accept the litigation of investors due to their status as an "inappropriate plaintiff." In the case of "*Ning Guang Xia*," investors claimed for compensation, but this was not accepted by the court. The response of the court was that "the case shall await further interpretations of laws and regulations concerned."[449]

In early 2002, the regulation *Some Provisions of the Supreme People's Court on Trying Cases of Civil Compensation Arising from False Statement in the Securities Market* was issued by the Supreme People's Court to affirm the principle of the legitimacy of civil compensation. In December 2002, Mr. Li Guoguang, then Vice-President of the Supreme People's Court, announced in a conference on national adjudication work for civil and commercial laws that "shareholders shall have the right to file derivative suits and the courts shall accept the claims."[450] However, the

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[448] *Ibid.*

[449] Ning Guang Xia was listed on the Shenzhen Stock Exchange since 1994. It was one of the best "blue-chip" stocks with the second most mark-up of all Chinese stocks. False profit-making: RMB 771.56 million (1998 to 2001). It was required by the CSRC to pay a fine of RMB 0.6 million in 2002. After restructure, it is re-listed since December 16, 2002 under Special treatment (ST), which was a signaled stock whose financial status is treated as not normal by the stock exchange. This type of treatment has been taken by Shanghai and Shenzhen Stock Exchanges since April 22, 1998.

[450] The speech in Chinese was reported by Xia Hua News Agency, available online :

speech of Mr. Li has been treated by the courts as "reference instead of formal authority to hear the cases."[451]

During the period January 2003 to June 2004, it was reported in the press that the directors or senior management of over 10 public listed companies had absconded overseas with nearly RMB 10 billion, which had caused substantial losses to public companies and public investors.[452] Following such reports, the Supreme People's Court published the draft *Regulations on Several Issues Concerning Trials for Corporate Suit (No.1)* for public consultation and comments. The draft provides basic guidelines for the acceptance of derivative actions,[453] but indicates that "China still plans to set highly restrictive requirements for plaintiff shareholders."[454] Section 44 of the draft Regulations requires that the plaintiff shareholder(s) must meet two conditions: (1) they must have held the company's shares when the interests of company were infringed and continue to hold them; (2) they must hold at least 1% of the company shares.

The draft laid a solid foundation for the subsequent revision of the *Company Law* in 2006, which officially provides that derivative action shall be accepted by all levels of courts in China, but requires that the 1% ownership requirement is kept and expresses the condition of "continuous holding" more precisely by the 180-day rule.[455]

b. Adjudication in practice

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http://news.xinhuanet.com/newscenter/2002-12/11/content_656845.htm

[451] It was stated by the Shenzhen Intermediate People's Court when it dismissed the appeals from an investor (Mr. Zhao Xinxian) against the director of San Jiu Medical & Pharmaceutical Cp., Ltd in 2003.

[452] Available online: http://fz.tx.gov.cn/dt.asp?id=254

[453] Art. 43-5.

[454] *Supra* Note 440, at 12.

[455] *Supra* Note 4, Sec.152.

(a) Traditional stance in common law jurisdictions

As a time-honored remedy across jurisdictions, derivative action represents an effective way for shareholders, and especially minority shareholders, to seek relief on behalf of the company.

The courts traditionally demonstrate an unwillingness to interfere with a commercial entity's business judgment and internal management for reasons of majority rule,[456] because the majority shareholders, who usually have a majority stake, can exercise their rights to their own advantage.[457] The courts are also aware of the potential motivation of greenmail by unscrupulous minority shareholders, the presence of which is determined by the court by distinguishing personal interests from company interests based on the facts of each case.[458] The court may refuse to grant relief if minority shareholders "bring an action after an unreasonable lapse of time or when they seek equity from the courts with unclean hands."[459] The courts are not willing to open the floodgates of litigation.

(b) Limited number of derivative suits involving listed companies

According to the Chinese law database "LawinfoChina"[460] (the largest and most complete legal database in China), approximately 140 derivative lawsuits were heard by the Chinese courts in the period 1 January 2000 to 31 December 2009. Only one derivative claim was filed by minority shareholders of a listed company (heard and

[456] L. S. Sealy, *Cases and Materials in Company Law* (7th ed.) (London: Butterworths, 2001), at 476.
[457] *Ibid*.
[458] *Ibid*.
[459] See *Nurcombe v. Nurcomber* [1985] 1 All ER 65.
[460] The database of "LawinfoChina" is operated by the LawinfoChina Co., Ltd., which is a legal information and education company, established by Peking University through its Legal Information Center. The "LawinfoChina" provides the subscriber with the most complete, accurate, and up-to-date legal information, available at: http://www.lawinfochina.com

decided upon by the Superior Court of Anhui Province in 2004[461]). All of the other derivative actions involved non-listed companies.

In terms of the defendant, the cases covered controlling shareholders,[462] supervisors,[463] directors, and senior executives.[464] In all cases the courts carefully reviewed the claimant's shareholding status to decide whether the plaintiff met the legal requirement.[465]

(c) State-held listed companies

Derivative claims by minority shareholders of listed companies are clearly rare in China, as no judgment on such a case could be found in the Chinese law database of "LawinfoChina" since the *Company Law* was revised in 2006.

In the particular case of state-held listed companies, the difficulty for the Chinese courts is not in hearing the cases or delivering orders, but in dealing with the conflicts between the interests of individuals (minority shareholders) and the state (the government as controlling shareholder). Lawsuits in China involving the interests of the state (e.g., state-owned shares) "are usually handled in line with political priorities such as social stability," which may have a "decisive impact" on the rulings of the courts.[466]

It is difficult for the courts in China to rule against the government for three

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[461] See *AnHui Fengyuan Pharmaceutical Company Limited v. Cheng Wenxian*, decided by the High Court of Anhui Province (2004) No.62.
[462] See for example *Real Estate Company of Nanchang District of Wuxi Municipal v. Heng Tong Group*, decided by the Intermediate Court of Wuxi (2000).
[463] See for example *Shanghai Jinren Glass Mechanics Limited Company v, Yao Moumou*, decided by Shanghai No.2 Intermediate Court (2009) No.510.
[464] See for example *Li Xiaozhaong v. Jin Rongzhong and others*, decided by Nanchuan People's Court of Chongqin (2006) No.538.
[465] See for example, *Jiang Zhiling v. Shen Lvsui*, decided by Beijing No.2 Intermediate Court (2009) No.09350. In this case, the Court dismissed the case because the plaintiff is not a shareholder but director of the company.
[466] *Supra* Note 162, at 259.

reasons. The first is that judicial justice in China is closely connected with the bureaucracy, given that the financial budgets of the courts (for example, the salary of judges and the operating expenses) are determined by local governments at the same level.[467]

The second is that misconduct is generally punished by the CSRC, and the minority shareholders of listed companies (specifically state-held listed companies) cannot effectively make derivative claims. In a typical case, the CSRC officially arranges for corrective action against illegal fund-diversion by the controlling shareholders of state-held listed companies, rather than legally punishing them. That is to say, the controlling shareholder in question is not legally liable as long as he or she is able to repay by the due time.

The third is that the Chinese government may have less incentive to ensure good corporate governance because non-tradable shares are not listed for public transaction, and thus fluctuations in share prices have no direct financial impact on the government. However, this does not justify the government paying no attention to the practical issues arising from corporate governance in state-held listed companies.

[467] Available online: http://www.city.china.com.cn/chinese/zhuanti/xxsb/699434.htm

Chapter V Two-tier Board Structure

> "A robust and pragmatic governance framework provides a balance between accountability and responsiveness, between empowerment and organizational alignment, and between risks and returns."
>
> Temasek Review (2009)

5.1 Overview of the board of directors

The board of directors is crucial to corporate governance, as it acts as a bridge between shareholders and executives. The board is in charge of the business management of the company. Both the UK *Combined Code*[468] and the *Corporate Governance Code of Singapore*[469] take the effectiveness of the board as the main principle of corporate governance by stating that the board is "collectively responsible for the success of the company."

5.1.1 Responsibilities of the board of directors

In China, the board of directors of public listed companies must comprise 5-19 persons and may include democratically elected employee representatives of the company.[470] The board focuses on the business operations of the company. Under Section 47 of *PRC Company Law*, the board has the authority to determine the "operation plans and investment programme."[471] Related to this authority, the shareholder's general meeting has the power to decide the "operation guidelines and

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[468] The *Combined Code* of UK, A.1. The *Combined Code* was first issued in 1998 and has been revised in 2003, 2006 and 2008. The current 2008 edition applies to the accounting periods beginning on or after 29 June 2008.

[469] The *Code of Corporate Governance* (*2005*), Principle 1. The *Code of Corporate Governance*, issued in July 2005, took effect from AGMs held on or after 1 January 2007. Listed companies should disclose their corporate governance practices and explain deviations from the Code of Corporate Governance in their annual reports for AGMs held from 1 January 2007 onwards.

[470] *Supra* Note 4, Sec. 109.

[471] *Ibid.* Sec.47(3).

investment plan" pursuant to the provision in respect of the general meeting's authority under the *PRC Company Law*. [472] The terms "plan" and "guidelines" in terms of operations and "programme" and "plan" with respect to investment are not further statutorily defined. The relative authority over operations and investment of the board and the general shareholders is not ascertained by law, and should thus be clarified in the articles of association.

A board of directors can enhance its effectiveness by "permitting directors both to use and develop expertise in specialized areas and to focus their energies on a subset of issues confronting the corporation."[473] The board formulates the regulations that distinguish the duties and functions of the various committees of the board,[474] which should all regularly report to the board.[475]

5.1.2 Internal control

A. Internal control in common law jurisdictions

The UK Turnbull Review defines an internal control system as encompassing "the policies, processes, tasks, behaviours and other aspects of a company [that] facilitate its effective and efficient operation by enabling it to respond appropriately to significant business, operational, financial, compliance and other risks to achieving the company's objectives."[476] In Singapore, internal control has a broader scope than in the UK Turnbull Review, extending to the "risk management policies and systems established by the Management" and "accounting control," which are expressly stipulated by the

[472] *Ibid*. Sec.38(1).
[473] Lynne L. Dallas, "The Multiple Roles of Corporate Boards of Directors" (2003) 40 San Diego L. Rev. 781, at 789.
[474] See also Conference Board Inc. (Canada), "Corporate Governance Best Practices: A Blueprint for the Post-Enron Era" by Carolyn Kay Brancato & Christian A. Plath (May 2003), at 23.
[475] *Ibid.*
[476] *Supra* Note 477, §20.

Companies Act[477] of Singapore and the *SGX Listing Manual*.[478] The *Singapore Code of Corporate Governance* requires an audit committee comprising internal or external auditors to annually review the effectiveness of control, and stipulates that the board "should comment on the adequacy of the internal controls in the company's annual report."[479] In the United States, the Sarbanes-Oxley Act requires the annual report of a company to contain an internal control report that specifies the "responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting." Moreover, a registered public accounting firm that issues the audit report for the company must attest to the assessment made by the management of the company.[480]

B. China

Pursuant to Section 47 of the *PRC Company Law*, the board of directors is in charge of the internal administration structure and business operations.[481] The *Guidelines on Comprehensive Risk Management in Central Enterprises* issued by the SASAC, which requires the establishment of comprehensive internal control systems in central SOEs.[482] The establishment and maintenance of internal control are the board's main corporate governance responsibilities,[483] which covers financial,

[477] Sec. 199(2A) and 201B(5)(ii);
[478] *Singapore Listing Manual*, Rule 719.
[479] *Supra* Note 469, Guidelines 12.1 and 12.2.
[480] *Supra* Note 113, Sec.404.
[481] *Supra* Note 4, Sec. 47 (8) and 47(10).
[482] It is issued by the SASAC, (2006) No.108, with effect from 6 June, 2006. The Article 3 and 34 require that "the system comprises of reporting, approval, liability, inspection, evaluation of the risks in operation, finance, market, law and strategies".
[483] *Internal Control: Guidance for Directors on the Combined Code* (The Turnbull Guidance) 1999, §15.

operational, and compliance control.[484] The purpose of internal control is to "ensure the reliability of financial statements, to facilitate corporate officers' knowledge of their corporation's business practices and to prevent public misstatements, fraud, and the misuse of assets."[485] How shareholders strike a balance between making the board accountable and giving the board sufficient space to manage the company depends on how the internal control system works.[486]

The Shanghai and Shenzhen Stock Exchanges demand that each listed company include an internal control report (evaluated by auditors) in its annual report.[487] Internal control is a long-term task for the survival of public listed companies under intense market competition. Well-organized internal control involves an integrated system with multiple offices.

Internal control in a typical trading company can be taken as an example. The trading team is at the front desk; risk control and legal teams are in the middle; and the finance team (settlement, accounts, and treasury) constitute the back office. A flow chart of internal control process is presented in Figure 5.1. When the trading team is going to make a deal with a new counter party, it submits an application for approval and registration to the risk control department authorized by the board of directors. When the counter party is not new, then it is subject to credit review by risk control by checking the credit limit. In the execution of transaction, the deal recap

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[484] Melvin Avon Eisenberg summaries the historical development of the widening meaning of internal control in his research paper of "The Board of Directors and Internal Control" (1997) 19 Cardozo L.R. 237.

[485] Wilson Meeks, "Corporate and White-Collar Crime Enforcement: Should Regulation and Rehabilitation Spell An End to Corporate Criminal Liability?" (2006) 40 Colum.J.L.& Soc.Probs. 77, at 90-1.

[486] Philip Wickham & Peter Townsend, "The Non-executive Director: A Management Perspective" (1994) 15(7) Company Lawyer 211, at 212.

[487] The *Internal Control Guidelines of Listed Company*, issued by Shanghai Stock Exchanges, with effect from July 1, 2006; The *Internal Control Guidelines of Listed Company*, issued by Shenzhen Stock Exchanges, with effect from July 1, 2007.

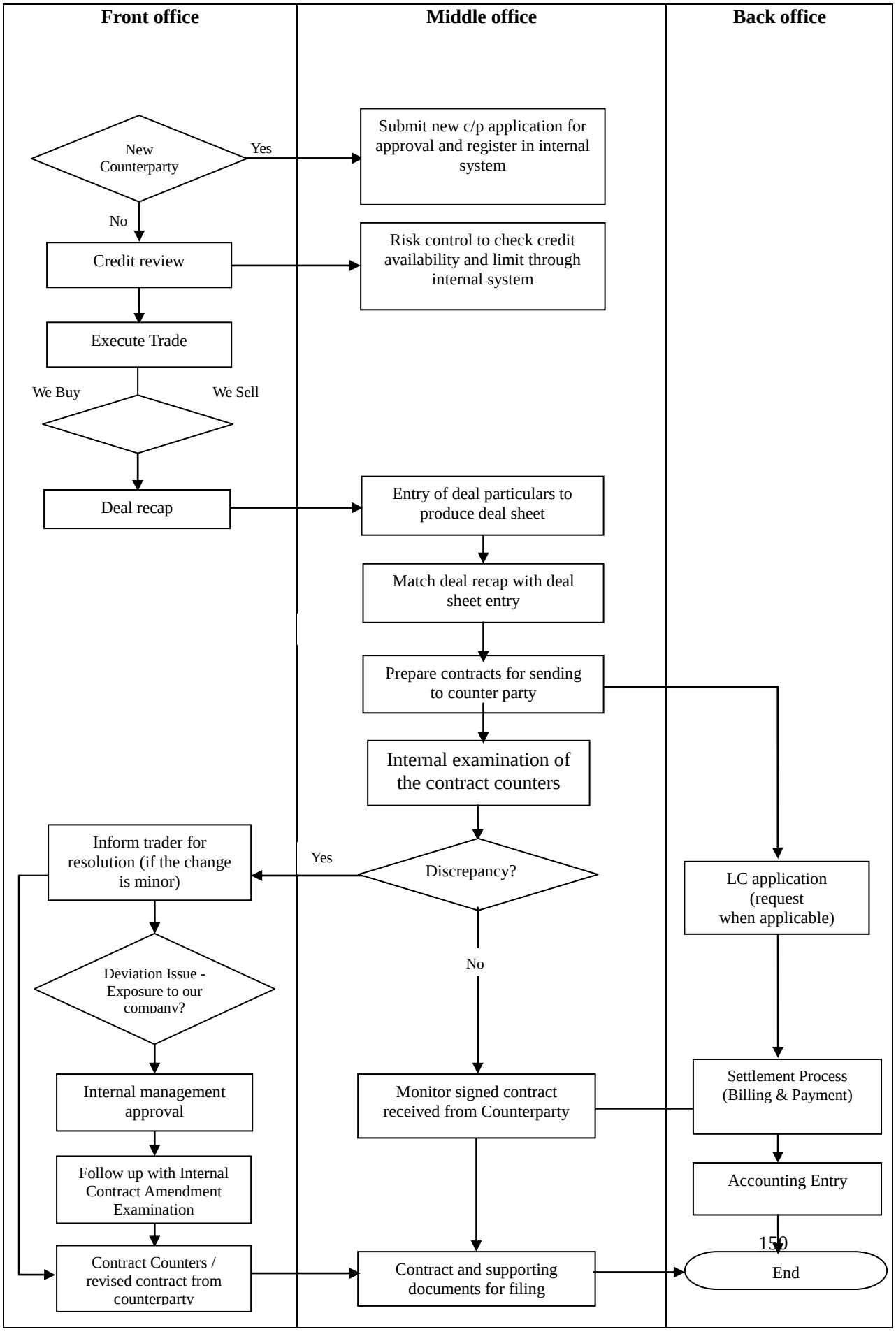
sent by the counter party must be verified against the deal sheet produced by the internal system upon entry of the deal particulars. The contract of sale or purchase is then prepared by appropriate time to send to the counter party. The counters to the contract from the counter party are also subject to internal examination, and risks with respect to payment terms, pricing quotations, and legal compliance should be reviewed and identified. If the terms of the counters deviate from the standard format, then the trading team may seek the approval from management based on the business considerations. If no discrepancy is found, then the trading team shall proceed with the contract signing and filing. The finance team in the back office deals with the payment matters (such as applying to the bank for issuing letter of credit) within the authorized limit in accordance with the board resolution. The settlement and account entry must also be completed in due course.

A sound system of internal control "reduces, but cannot eliminate, the possibilities of poor judgment of decision making, human error . . . and the occurrence of unforeseeable circumstances."[488] Internal control provides "reasonable" rather than "absolute" control to achieve the company's business aims.[489] Hence, the effectiveness of the internal control system is regularly updated and adjusted by the board of directors.

[488] *Supra* Note 477, §22.

[489] See the explanation of "reasonable test" in Lyman P.Q. Johnson & Mark A. Sides, "The Sarbanes-Oxley Act and Fiduciary Duties" (2004) 30 Wm. Mitchell L. Rev. 1149, at 1195-6.

Figure 5.1 Flow Chart of Internal Control



5.1.3 Director

A. Who are the directors?

A director is *sui generis* in character, and can mean trustee, agent, or managing partner at different times.[490] A director is defined in corporate law of the United Kingdom and Singapore as "any person occupying the position of director, by whatever name called,"[491] including both *de jure* directors and *de facto* directors.[492] Moreover, the UK *Companies Act* defines a "shadow director" as a person "in accordance with whose directions or instructions the directors of the company are accustomed to act," but it excludes those who give advice in a professional capacity or give directions or instructions to subsidiaries.[493] The *PRC Company Law* does not give any general meaning or specific classification of "director."

The clear division of responsibility between board and executive must be pursued to ensure the balance of power and avoid the concentration of power in one person (Chairman or CEO).[494] For this reason, the chairman and chief executive officer (CEO) must be separate persons. Under the *PRC Company Law*, directors may concurrently be senior executives. In 10.1% of Chinese listed companies, the chairman and the CEO is the same person.[495] Even if the two positions are separately held, it is common for one party to have controlling power over the other side,

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[490] See *Regal (Hastings) Ltd. v. Gullier* [1942] 1 All ER 378, 387; see also Re Lands Allotment Co [1894] 1 Ch. 616, at 631 and *JJ Harrison (Properties) v. Harrison* [2002] 1 B.C.L.C. 162, 173.

[491] *Supra* Note 118, Sec.250; *Supra* Note 328, Sec.4.

[492] In the case of *Re Hydrodam (Corby) Ltd.* [1994] 2 BCLC 180, the Court identifies that "to establish that a person is a *de facto* director, it is necessary to pleas and prove that he undertakes functions in relation to the company which could properly be discharged only by a director".

[493] *Supra* Note 118, Sec.251; See *Ultraframe v. Fielding* [2005] EWHC 1638.

[494] *Supra* Note 468, A.2; *Supra* Note 469, Guidelines 3.1

[495] *Supra* Note 361, at 34.

demonstrating a formalistic separation and actual integration.[496]

There is no provision in the *PRC Company Law* concerning the election of directors.[497] The *CG Code* requires that detailed information about the candidates for directorship be publicly disclosed before the convening of the shareholders' meeting,[498] and that candidates must guarantee the truthfulness and completeness of this information.[499]

In practice, the election process may not be as "open, fair, impartial and independent" as required by the *CG Code*.[500] Around 40% of listed companies in China have no specific internal rules in their articles concerning detailed nomination and voting procedures for directors.[501] According to a survey by the Shanghai Stock Exchange, there are five forms of nomination, including nomination by shareholder(s), by the board of directors, by the chairman, by the board of directors after discussion between the chairman and the majority shareholders, and by the nomination committee of the board. Of these, the first (nomination by shareholders) and the fourth (nomination by the board of directors after discussion between the chairman

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[496] The Section 120 of *Company Law 1993* (annulled) provides that "the chairman is authorized to exercise partial powers of the board during the closure time of board meeting". This provision, failing to provide the specific scope of the powers for chairman to exercise, has been removed by the revised *Company Law 2006*. But the other powers remain in *Company Law 2006,* such as presiding over general meeting, calling and presiding over board meeting, and checking the implementation of board decisions. See Sec.102 and 110, *PRC Company Law*.

[497] The Shanghai Stock Exchange released a new regulation *Guidelines of Appointment and Conduct of Directors in the Public Listed Companies*, which came into force on 25 August 2009. The Article 8 of the Regulation provides the requirement of the candidate for a director of public listed company: "he/she shall not be punished by the CSRC or publicly criticized for more than two times by the Shanghai Stock Exchange over the latest three years". The Shenzhen Stock Exchange has not yet given such guidance.

[498] *Supra* Note 10, Art.29.

[499] *Ibid.* Art.30.

[500] *Ibid.* Art.28.

[501] *Supra* Note 361, at 83.

and the majority shareholders) are the most common in listed companies.[502] The survey finds that the nomination of directors in state-held listed companies in China is substantially influenced by the controlling shareholders.[503]

B. Director's duty

The director has two duties under the *PRC Company Law*: duty of loyalty ("*Zhongshi Yiwu*") and duty of diligence ("*Qinmian Yiwu*").[504]

(A) In the context of common law jurisdictions

a. Fiduciary duty

Fiduciary duty in common law jurisdictions is deeply entrenched in the equity and trust laws, and is one of the fundamental assumptions from which duties derive. Fiduciary duty in common law jurisdictions has developed into a more systematic framework of key elements based on certain common law rules,[505] supplemented with the additional touchstones in various jurisdictions for the evaluation of a director's duty, such as independent judgment,[506] fairness to the company,[507] and confidentiality.[508] There are three basic elements of fiduciary duty in common law.

First, the director must be honest and have good faith (bona fide) in the

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[502] *Ibid.* at 68.
[503] *Ibid.* at 82-3.
[504] *Supra* Note 4, Sec.148.
[505] See generally *Mutual Life Ins Co of New York v. Rank Organization* [1985] B.C.L.C. 11 and *Neptune (Vehicle Washing Equipment) v. Fitzgerald* (No.2) [1995] B.C.C. 1000.
[506] *Supra* Note 118, Sec.173. The ICGN Statement on Global Corporate Governance Principles defines "independent judgment" as "judgment in the best interests of the corporation free of any external influence that may attempt to be or may be or may appear to be exerted on any individual director or the board as whole".
[507] American Bar Association, *Corporate Director's Guidebook* (Chicago, Ill.: American Bar Association, 1978), at 5.
[508] *Supra* Note 4, Sec. 149(7).

company's interests. This is a subjective test as to the director's state of mind.[509] Nevertheless, in the absence of evidence on this subjective state of mind, the test follows an objective approach to discover the director's reasonableness in the transaction.[510] In the case of a group companies, *Charterbridge Corporation Ltd v Lloyds Bank Ltd* (1970) Ch 62 held that "each company in the group is a separate legal entity and the directors of a particular company are not entitled to sacrifice the interest of that company." The essence of the fiduciary obligation lies in the "surveillance and justiciability of motive,"[511] so that the duty may only be evaluated by motive rather than by results.[512] However, propriety of motive is not provided for in law and is difficult to prove.[513]

Second, the director must exercise his or her powers for proper purposes. Directors shall be liable if they have "exercised their powers for a purpose different from that for which the powers were conferred upon them" by law or by articles.[514] There are three approaches: the first approach is a strict standard of equity law applied to a trustee, who must exercise the power for the specific purpose of the beneficiary.[515] The second approach is to determine whether the director does so

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[509] See *Re Smith & Fawcett Ltd* (1942) Ch 304.
[510] *Intraco Ltd. v. Multi-Pak Singapore Pte. Ltd.* [1995] 1 SLR 313.
[511] See Lionel Smith "The Motive, Not the Deed", Chapter 4 in J. Getzler (edited), *Rationalizing Property, Equity and Trusts: Essays in Honour of Edward Burn* (London: Butterworths, 2003) 53.
[512] *Ibid.*
[513] In the early case *Hindle v. John Cotton Ltd* (1919) 56 Sc.L.R. 625, 630-1, it is stated that "the state of mind of those who acted, and the motive on which they acted, are all important, and you may go into the question of what their intention was, collecting from the surrounding circumstances all the materials which genuinely throw light upon that question of the state of mind of the directors so as to show whether there were honestly acting in discharge of their powers in the interests of the company". See also the consenting comments of Lord Wilberforce in *Smith v. Ampol* [1974] A.C. 821, 835.
[514] *Supra* Note 85, at 385
[515] *Keech v. Standford* [1994] 3 SCR 377

honestly and in good faith with the best interests of the company in mind.[516] This approach overlaps the first element of fiduciary duty. The third approach is to determine the substantial purpose for which the power has been exercised, such as whether the purpose of the allotment was to raise funds or to dilute the plaintiff's shareholding to a minority.[517]

Third, a director should avoid conflicts of interest. This element is composed of two rules: the non-conflict rule and the non-profit rule. Judge Vinelott in the *Movitex* case[518] clarifies two categories of conflict: one between duty and personal interest and the other between the company's interest and the director's own interest. This includes both direct interest and indirect interest, which may be obtained from usurping the company's opportunity, or the misuse of information or property.[519] It is immaterial whether the company could take advantage of the property, information, or opportunity.[520] As Lord Macmillian states in the *Regal* case[521] "directors are accountable for any profit which they made if it was by reason and in virtue of their office," a director of a company must not accept a benefit from a third party conferred for reason of him or her being a director, or by doing (or not doing) anything as a director.[522]

Both the UK and Singapore corporate laws require disclosure as a statutory

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[516] *Supra* Note 505.
[517] *Howard Smith Ltd. v. Ampol Petroleum Ltd.* [1974] AC 821. For the share issue to create voting power, see *Mills v. Mills* 60 C.L.R. 150. See also *Clemens v. Clemens* [1976] 2 All E.R. 268.
[518] *MovitexLtd v Bulfield* (1988) BCLC 104
[519] See *Canadian Aero Service v O'Malley* (1973) 40 DLR (3d) 371, *Bhullar v Bhullar Re Bhullar Bros Ltd* (2003) EWCA 424, *Boardman v Phipps* (1967) 2 AC 46, *Industrial Development Consultants Ltd v Cooley* (1972) 2 All ER 162.
[520] *Supra* Note 118, Sec.175(2).
[521] *Regal (Hastings) Ltd. v. Hudson* (1978) 52 ALJR 399.
[522] *Supra* Note 118, Sec.176(1).

duty.[523] The time limit in the UK is a little ambiguous, as it requires the declaration to be made before the company enters into the transaction or arrangement.[524] In Singapore it is much clearer. For an interested transaction, the director must declare "as soon as practicable after the relevant facts have come to his knowledge."[525] For other arrangements, declaration should occur after he or she becomes a director or takes possession of the property.[526] Disclosure relieves criminal liability but not civil liability.[527] The consequence of disclosure is subject to the company's authorization, with the conditions of abstaining from voting and non-attendance at directors' meetings .[528]

b. Duty of diligence[529]

The landmark Australian case *Daniels v. Anderson*[530] distinguishes the extent of duty between executive and non-executive directors. For executive directors, the standard of care is objective, and refers to a reasonable man of ordinary prudence running the company. The duty is not only judged on the substantial elements of the business decision itself, but also more importantly on the procedural aspects, such as whether the director is enquiring and keeps him or herself informed about decisions, whether he or she is taking any further decisions, and whether he or she is supervising how the executives are implementing the decision. That is to say, a director should

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523 *Ibid*. Sec.177; *Supra* Note 316, Sec.156.
524 *Ibid*. Sec.177(4).
525 *Ibid*. Sec.156(1).
526 *Ibid*. Sec.156(6).
527 *Hely-Hutchinson v. Brayhead Ltd.* [1968] 1 QB 549.
528 See for example *supra* Note 118, Sec. 175(5).
529 The distinction of director's fiduciary duty and duty of care is stated by Ipp J. in *Permanent Building Society v. Wheeler* (1994) 14 A.C.S.R. 109, 157 that "the director's duty to exercise care and skill has nothing to do with any position of disadvantage or vulnerability on the part of the company. It is not a duty that stems from the requirements of trust and confidence imposed on a fiduciary".
530 (1995) 13 ACLC 614.

take as much care in the affairs of the company as he or she would reasonably take in his or her own affairs. For non-executive directors, the test is also objective, although the demands are understandably less than those for executive directors. Non-executive directors must acquire at least a rudimentary understanding of the business and should assume a continuing obligation to keep themselves informed about corporate activities. Another Australian case *ASIC v. Rich*[531] even held that the legal duties imposed on the chairman of the board may be extended.

The English case *Re Barings Plc (No.5)*[532] approved the *Daniels* judgment and confirmed that directors remain responsible for the performance of delegated functions and have, both collective and individually, a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business.[533] "Reasonableness" in law is used as a standard, and is defined by Black's Law Dictionary as involving the determination of "whether someone acted with negligence" or "exercised the degree of attention, knowledge, intelligence, and judgment."[534] In the UK, duty of reasonable care and diligence is a statutory duty.[535] The UK *Companies Act* defines this "reasonable" standard of care and diligence as that which "would be exercised by a reasonably diligent person with (a) the general knowledge, skill and experience that a person is reasonably expected to discharge the responsibilities that the director has assumed."[536]

The touchstones of the duty of care and diligence as set out in the cases of

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[531] (2003) NSWSC 85.
[532] [1999] 1 BCLC 433.
[533] *Ibid.* at 489.
[534] See Bryan A. Garner (Editor), *Black's Law Dictionary*, 8th ed. (St. Paul, MN: West, 2004), at 1294.
[535] *Supra* Note 328, Sec. 157(1); *Supra* Note 118, Sec.174.
[536] *Supra* Note 118, Sec. 174(2). The American Law Institute (ALI) adopts a similar approach of "reasonable" test, but it was divided into two aspects: (i) inquiry: when "the circumstances would alert a reasonable director to the need"; (ii) reliance: entitled to rely on materials and persons. *Supra* Note 122, §4.01.

Daniels v. Anderson and *Re Barings Plc* were adopted by the Singapore court in the case of *Lim Weng Kee v PP.*[537] The Court held that the standards shall be the same for both civil and criminal breaches of duty.[538] This duty is recognized as "not fixed but a continuum" and will not be "lowered to accommodate any inadequacies in the individual's knowledge or experience" or be "raised if he held himself out to possess some special knowledge and experience."[539]

The business judgment rule is applied to review the duty of diligence. Three presumptions are generalized by the ALI: "(i) the director is not interested in the subject matter of the decision; (ii) the director is informed with respect to the business judgment to the extent he reasonably believes appropriate under the circumstances; and (iii) the director rationally believes that the business judgment is in the best interests of the company."[540] A sharp distinction has been drawn by the ALI between the "reasonableness" standard of duty of care and "rationally belief" in a business judgment rule. The "rationality" standard is intended to permit a significantly wider range of discretions than "reasonableness," which is less easy to satisfy.[541] Thus, directors would be given "a safe harbor from liability for business judgments" that may not arguably meet the "reasonableness" standard but could fall inside the "rationality" standard.[542] For such wider arrangements, Eisenberg explains the difficulty for the court to "distinguish between bad decisions and proper decisions that turn out badly" considering the incomplete information and potential risks

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[537] [2002] 4 SLR 327.
[538] *Ibid.* The Court held that "the aim of criminal liability was to protect the public interest by deterring directors from acting negligently, the test for such liability had to be sufficiently robust".
[539] *Ibid.* Para.28.
[540] *Supra* Note 122, §4.01(c). For more discussion, see Melvin Avon Eisenberg, "The duty of care and the business judgment rule in American corporate law" (1997) 185, at 187.
[541] *Ibid.* at 142.
[542] *Ibid.*

involved.[543]

The Delaware approach to the business judgment rule is summarized in *Re Walt Disney Company*[544] as being to serve to protect and promote the role of the board, because courts are not well equipped to engage in post hoc substantive reviews of business decisions.[545] The presumptions of the business judgment rule apply when there is no evidence of "fraud, bad faith, or self-dealing in the usual sense of personal profit or betterment" on the part of directors.[546]

The US-originated concept of the business judgment rule has found its way to other jurisdictions both through express statutory provision and implicit judgments. For example, the *Australian Corporations Act 2001* includes the business judgment rule, which adds to the three ALI presumptions the fourth presumption that a director shall make the judgment in good faith for the proper purpose, but still insists on the "rationality" standard.[547] The *German Corporate Governance Code* includes the term "business judgment rule" while adopting the "reasonableness" standard.[548] The Singapore High Court implied the "judicial endorsement of sanctity of business judgment" for the first time in the local case of *Vita Health v. Pang Seng Meng*.[549]

(B) China

a. Legislation

(a) Fiduciary duty

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543 *Supra* Note 536, Melvin Avon Eisenberg, at 189.
544 2005 Del. Ch. LEXIS 113.
545 *Ibid*. at Para.150-1
546 *Ibid.*
547 Sec.180(2).
548 *German Corporate Governance Code*, §3.8. The *German Corporate Governance Code* is adopted by Government Commission of Germany on 26 February, 2002 and comes into force on 26 July, 2002.
549 [2004] SGHC 158.

The term "duty of loyalty" in China was legally transplanted[550] from the "fiduciary duty" of common law jurisdictions into the *PRC Company Law (1993)* by simply stating that "directors and managers shall faithfully perform their duties and protect the interests of the company" without any statutory definition.[551] The "duty of loyalty" is expressly confirmed by the revised *PRC Company Law (2006)*, which specifies a variety of forbidden acts, including misappropriating company funds, depositing company funds into an account under the director's own name or any other individual's name; accepting commissions on transactions, illegally disclosing the company's confidential information, and causing losses to the company by taking advantage of related party relations.[552]

The literal meaning of "loyalty" is that directors should be loyal to the company such that their activities do not infringe upon the interests of the company. Due to the lack of conceptions of equity and trust in corporate law in China, an executive director is not a trustee, but merely an employee. Hence, a director is not considered to be "fiduciary" in China, but should be loyal to the company as an employee according to the employment contract between the director and the company. For a non-executive director, who is usually not an employee of the company, shall also meet the statutory requirement for "duty of loyalty".

(b) Duty of diligence

In China, the duty of diligence was provided for in the 2006 *PRC Company Law*

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[550] Japan added to its *Commercial Code* in 1950 a new statutory provision concerning director's duty of loyalty, which was a direct import from the UK. See *Commercial Code 1981*, Sec. 254(3). For Detailed discussion of the background and process of import, see Hideki Kanda & Cutis J. Milhaupt, "Re-examining Legal Transplant: The Director's Fiduciary Duty in Japanese Corporate Law" Working Paper Np.219, Columbia Law School.

[551] *Supra* Note 208, Sec.123.

[552] *Supra* Note 4, Sec.149 and Sec.21.

for the first time, but the law does not give substantive content to this duty. The *Articles Guidelines* add that the director should have knowledge of the operation of the company and certify the periodical and annual reports.[553]

The latest *Guidelines for Appointment and Conduct of Directors in Public Listed Companies*[554] issued by the Shanghai Stock Exchange requires that "directors should act in the best interest of the company, and their decision shall be made based on the consideration of what a similar person would do in similar circumstances.[555] When the director is absent from board meetings for no less than one third of all meetings held in the same year, the supervisory board of a listed company should investigate the conduct of the director in question and disclose their investigation results to the public.[556] If a director is absent from one half of all meetings without appropriate cause, then it will be announced by the Shanghai Stock Exchange public that he or she is not qualified for directorship of listed companies for the next three years.[557]

b. Judicial application

There are three types of legal liability arising from a breach of directors' duties: (i) civil liability, in which the director "shall be liable for compensating for the losses that has been caused to the company"[558] unless he or she is able to make the defense that "he or she has challenged the resolution to the board and the dissenting opinion has been recorded in the minutes of the board meeting;"[559] (ii) administrative discipline is meted out by the CSRC for misconduct by directors of listed companies

553 *Supra* Note 14, Art.98.
554 *Supra* Note 497.
555 *Ibid*. Art. 22.
556 *Ibid*. Art. 27.
557 *Ibid*.
558 *Supra* Note 4, Sec.150.
559 *Supra* Note 10, Art.38.

that breaches the provisions of the *Securities Law;*[560] (iii) criminal liability, in which the criminal conviction of tunneling by a director, supervisor, senior executive, or controlling shareholder in relation to the tunneling discussed in the Chapter IV is also taken as a breach of a director's duty of loyalty and diligence.[561]

(a) Duty of loyalty

According to the "LawinfoChina" database, approximately 38 lawsuits concerning a breach of loyalty duty were heard by the Chinese courts between 1 January 1993 and 31 December 2009. All of the claims involved non-listed companies.

The Chinese courts review the specific facts and circumstances involved with such breaches to determine whether or not the director has breached the duty of loyalty, but have not developed any rules or situations for applying corporate law to the duty breach (or at least, their rules are not reflected in the case summaries published and collected in the database of judicial cases).[562]

It is a fundamental principle that the courts will not second-guess business decisions with the advantage of hindsight.[563] However, in certain circumstances, a court may grant whole or partial relief, if it thinks fit and it appears to the court that the director has acted honestly and reasonably and that he or she ought fairly to be excused for the negligence, default, or breach.[564] The procedural arrangements for directors for disclosure and reporting relieve a director from the risks or expenses of

560 *Supra* Note 5, Sec.188-225.
561 *Supra* Note 410, Sec.169. See for reference the part of C(c) of 6.4.2 in Chapter IV.
562 *Supra* Note 507, at 54.
563 See *Burland v. Earle* [1902] AC 83, at 93; *ECRC Land Pte Ltd v. Wing On Ho* [2004] 1 SLR 105.
564 *Supra* Note 328, Sec.391.

judicial litigation.[565] Thus, the law sets out a range of procedural requirements for directors to justify their actions before a court.[566] In accordance with the *PRC Company Law*, only a few acts of directors can be discharged in circumstances in which a director is interested, directly or indirectly, in a proposed transaction or such arrangements as holding office or owning property to provide loans or guarantees to a third party, self-dealing with the company, taking up business opportunities belonging to the company by taking advantage of his or her position, or engaging in a business similar to that of the company.[567] A director must declare the nature, fact, or extent of interests or conflicts and obtain approval at a general meeting or board meeting, or in the manner set out in the articles of company.

(b) Duty of diligence

Sixteen lawsuits were found in "LawinfoChina" relating to breaches of diligence duty filed by companies or their shareholders against directors, supervisors, or top executives for the period 1 January 2006 to 31 December 2009. None of the lawsuits involved public listed companies.

According to official statistics,[568] over 700 directors of listed companies in China received administrative discipline from the CSRC between 2001 and 2008. As at the end of 2008, three lawsuits had been filed by directors against the CSRC for the disciplines imposed on them. One of the claims was thrown out by the court, which decided that it had no jurisdiction over the time-barred case.[569]

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[565] *Supra* Note 85, at 21 and 24.
[566] *Ibid.* at 441-2.
[567] *Supra* Note 4, Sec.149 and Sec.21.
[568] Shanghai Securities News (CSRC's official press coverage for information disclosure of listed companies), 4 December, 2008, available online: http://www.cnstock.com/paper_new/html/2008-12/04/content_66446861.htm
[569] Mr. Lu Jiahao, who was independent director of Zhenzhou Baiwen Company

In the other two cases, both courts decided in favor of the CSRC. One case concerned the application of the *Securities Law* to administrative discipline by the CSRC, challenged by Mr. Huang Yong, Deputy Chairman of Shenzhen Heguang Commercial Company Limited in 2007.[570] The other case was a benchmark case, and was the first case in China in which the court decided the duty of diligence of a director of a listed company. The claimant was Mr. Ding Liye, director of Shenxin Taifeng (Group) Company Limited (ST Company), who was given a fine of RMB 30,000 by the CSRC because the disclosure of ST Company contained false records, misleading statements, and major omissions. In this case, Mr. Ding authorized another person to attend the board meeting at which the impugned disclosure was discussed and approved. The Court held that the director could not rely on his absence from the meeting to justify his breach of duty of diligence. The Court also rejected the claims of Mr. Ding on the fine imposed on him by the CSRC. [571]

The duty of diligence is still new to the courts in China, and there have been only a few court decisions on the matter over the past few years since the revised *PRC Company Law* came into effect in 2006. The Chinese courts have not clarified their position on the implications of the duty of diligence. When judges review the circumstances and effects of the impugned conduct, they often take into consideration the duty of diligence together with the duty of loyalty. In other words, they view it in conjunction with the overarching background of the factual matrix, which may

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Limited, was liable on conviction to a fine of RMB one hundred thousand by the CSRC in 2001. His appeal to the CSRC was rejected by CSRC in Feb 2002. Then Mr. Lu filed a claim to the No.1 Intermediate People's Court against CSRC in May 2002 and the claim was thrown out by the Court. His appeal to the High Court of Beijing was dismissed.

[570] Shanghai Securities News, 29 November 2007, available online: http://news.xinhuanet.com/fortune/2007-11/29/content_7164226.htm

[571] *Ibid.*

comprise clear evidence of disloyalty or non-diligence that amounted to the breach.[572] The duties of loyalty and diligence are themselves "a notoriously complex instrument of corporate governance in definition, application, and enforcement, regardless of the nationality or state of development of the jurisdiction implementing it."[573] Because the duties of directors are not specifically spelt out by legislation in China, the courts usually observe the facts by observing the conduct itself (either a single act or a course of conduct), the cumulative effects of the conduct (loss or damage to the company, if any) and the knowledge of the director, supervisor and senior executive in question, rather than setting strict guidelines as to what may constitute a breach of duty. Scrutiny of the duty of loyalty and duty of diligence of the defendant follows an objective standard, which means that the defendant's performance is evaluated in accordance with their involvement in the functions and occurrences.[574]

5.2 Two-tier boards

The one-tier or unitary board structure is based on the board of directors as the sole authority over the management of the company. The directors of one-tier board

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[572] The cases in which the defendant is director of the company: see *supra Hao Ling v. Wang Jiyan*; see also *Zhao Hao v. Beijing Bai Li Xing Real Property Development Limited Company*, decided by Beijing No.2 Intermediate Court (2009) No.13966. The defendant is director of the company. The cases in which the defendant is supervisor of the company: see *supra Shanghai Jinren Glass*. The cases in which the defendant is senior executive of the company: see *Beijing International Yiyuan Limited Company v. Xue Wen*, decided by People's Court of Dongcheng District of Beijing (2006) No.8542; see also *Beijing Yanjing Construction Engineering Limited Company v. Yang Guoqing*, decided by People's Court of Dongcheng District of Beijing (2008) No.3957. The full text of cases are located in the database of "Chinalawinfo",

[573] Nicholas C. Howson, "The Doctrine That Dared Not Speak its Name: Anglo-American Fiduciary Duties in China's 2005 Company Law and Case Law Intimations of Prior Convergence", in *Transforming corporate governance in East Asia* (edited by Hideki Kanda, Kon-Sik Kim & Curtis J. Milhaupt) **(**New York, NY: Routledge, 2008), at 200.

[574] Chee Keong Low, "A Road Map for Corporate Governance in East Asia" (2004) 25 Nw. J. Int'l L. & Bus. 165, at 183.

share a "common responsibility," whether executive or non-executive, inside or outside, independent or non-independent. The one-tier structure ensures information sharing or communication.[575] In contrast, the two-tier or dual board arrangement focuses on the internal monitoring of management, where a clear "division of duties between organs" is made.[576]

All joint stock companies (including listed and non-listed companies) in China are required by the *Company Law* to have two-tier boards. This was transplanted and incorporated from Germany into the 1993 *Company Law*. At the same time, the board of directors of all public listed companies should have independent directors according to the *ID Guideline* of the CSRC.[577] The compulsory inclusion of independent directors was transplanted from the United States. Since 2002, all public listed companies in China must have independent directors and a supervisory board as part of their internal governance structure.

5.2.1 Independent directors

A. Historical development

(A) United States

Before the Great Depression of the 1930s, the United States had always pursued a "classic liberalism" or "laissez-faire" economic policy.[578] Based on the tenets of "individual freedom and limited government,"[579] government interference in economic development was seen as unnecessary, and individual property rights and

[575] *Supra* Note 51, at 106.
[576] *Ibid.* at 107.
[577] *Supra* Note 11.
[578] *Supra* Note 106, at 8-10.
[579] See David Conway, *Classic Liberalism: The Unvanquished Ideal* (Palgrave Macmillan, 1998). See also Razeen Sally, *Classic Liberalism and International Economic Order: Studies in Theory and Intellectual History* (Routledge, 2002).

the free market were strongly respected and protected.[580]

Since the 1930s, government intervention has been exercised to correct and regulate the underlying flaws in the market, such as "unscrupulous monopoly, high unemployment, income inequality and massive pollution by industrialization.[581] The US federal government once adopted the "laissez-faire" policy in economy during earlier years and began to exercise its intervention where market flaws came forth and economic defects were out of control in the late 1930s.

In the 1960s, the increasingly serious failure of the function of the board of directors was witnessed in US companies with a widely dispersed ownership structure. The independent director system was then introduced to try to strengthen the board and control the management in such companies.[582]

In the traditional business of the United States, which is dominated by public companies with a dispersed ownership, German-style social democracy would not be applicable.[583] In the political view of Roe, there are two reasons for such unsuitability. First, there are fewer social conflicts due to the high mobility of the population and economy, [584] and, more importantly, Americans have a "long and deep antigovernment bias," so that people do not strongly depend on government to solve problems.[585]

(B) China

The development of independent directors in China has gone from individually

[580] *Supra* Note 106.
[581] *Ibid.* at 10 and at 278-9.
[582] *Supra* Note 392, *Donald C. Clarke*, at 167.
[583] Mark J. Roe, "Political Preconditions to Separating Ownership from Corporate Control" (2000) 53 Stan.L.Rev. 539, at 541.
[584] *Ibid.* at 577.
[585] *Ibid.*

voluntary establishment to being a nationwide mandatory requirement. In 1993, Qing Dao Beer was the first Chinese listed company to voluntarily set up an independent director system. The *Guidelines of Articles of Association 1997* (Annulled)[586] encouraged public listed companies to introduce independent directors into their boards.

In 2001, the *ID Guideline* was issued requiring that each public listed company elect qualified persons to be independent directors. The timeline was that by June 30th, 2002, at least two members of the board of directors had to be independent directors, and by June 30th, 2003, at least one third of the board had to be independent.[587] The rising percentage of independent directors in listed companies is shown in Table 5.1. Up to 2001, the average percentage of independent directors was pretty low at less than 10%. This increased to 22.09% in 2002. Since 2003, the average percentage has risen to over 30% under the requirements of the *Guideline*.

Table 5.1 Statistics on Directors and Independent Directors in Public Listed Companies in China[588]

Year	Number of Directors	Number of Independent Directors	Average Percentage
1998	9.86	0.26	2.16%
1999	10.19	0.49	4.15%
2000	10.07	0.96	8.78%
2001	9.99	0.57	5.52%
2002	10.54	2.26	22.09%
2003	10.54	3.18	30.34%
2004	10.41	3.30	31.93%
2005	10.34	3.30	32.08%

586 Art.12. The 2006 revised version has superseded the 1997 version.
587 *Supra* Note 11, Art. 1(3).
588 *Supra* Note 277.

B. Implications of independent directors

Different jurisdictions have different legal interpretations of the term "independent director." Donald C. Clark (2007) uses the term "non-management director" as a general concept before distinguishing its various manifestations of "independent director," "outside director," and "disinterested director."[589] He defines a "non-management director" as a person who "is not a member of senior management team," which is a common negative feature of independent, outside, or disinterested directors.[590] The different implications of the three specific conceptions are that an "independent director" focuses on solving agency problems and balancing the interests of different groups,[591] an "outside director" is not be an employee of the company,[592] and a "disinterested director" is entitled to have conflict-of-interest transactions disclosed to them for approval.[593]

The term "outside" is replaced with "non-executive" in the UK *Combined Code*. A non-executive director is not involved in the executive work of the company, in contrast to the case of "executive directors."[594] Directors are usually categorized into executive and non-executive directors.[595] Executive directors devote themselves almost in a full-time capacity to corporate affairs, whereas non-executive directors do not. Thus, in a more strict way, an outside or non-executive director is not allowed to hold a post in the company. Being outside or non-executive is one of the conditions of

[589] Donald C. Clark "Three Conceptions of the Independent Director" (2007) 32(1) Delaware Journal of Corporate Law 77, at 78-83.
[590] *Ibid.* at 78.
[591] *Ibid.* at 84-5.
[592] *Ibid.* at 99-100.
[593] *Ibid.* at 102 and 105.
[594] See also Black, Bernard S., Cheffins, Brian R. & Klausner, Michael D., "Outside Director Liability" (2006) 58 Stanford Law Review 1055.
[595] Derek Higgs, "Review of the Role and Effectiveness of Non-executive Directors" (2003). See also *supra* Note 469, Guidelines 2.5.

independence. An independent director should be both non-executive and disinterested.

The term "employee" is defined by Black's Law Dictionary as "a person who works in the service of another person (the employer) under an express or implied contract of hire."[596] Strictly speaking, a person is not qualified as an independent director if he or she is employed by the company. Such employment relations are excluded by law in most jurisdictions,[597] and the relations between the independent director and company are in effect,founded upon a relationship of mutual trust and confidence.

C. Comparative research

A clear understanding of independent directors in Chinese public listed companies can be gained through a comparison of Singapore (*Code of Corporate Governance*), the United Kingdom (*Combined Code*), and the United States (*Sarbanes Oxley Act* and *New York Stock Exchange ("NYSE") Listed Company Manual*)[598] with respect to the definition of independent directors and compositions of the board and board committees.

(A) Definition of independent director

a. Structure

Table 5.2 shows that all four jurisdictions have inexhaustibly specified examples of non-independence. In addition, China sets out another two requirements: having

[596] *Supra* Note 530.
[597] *Supra* Note 469, Guidelines 2.1; See also *supra* Note 113 and 468.
[598] The US listed companies referred to in this section are limited to the companies listed on the New York Stock Exchange, regulated by its *NYSE Listed Company Manual*.

basic knowledge of corporate operations and possessing five years of relevant working experience in the law, economics, or other industry-related area.

b. Scope of examples

The examples of circumstances in which persons would be non-eligible as independent directors throughout the four jurisdictions cover relationships of employment, family, transaction, and professional service. Furthermore, in the United Kingdom, United States, and Singapore, cross-directorships or cross-executives are also considered. Under the UK *Combined Code*, a director is considered non-independent if he or she has served on the board for a continuous period of nine years.[599]

c. Meaning of independence

The meaning of "independence" in China and the United Kingdom has two aspects: independence from management and independence from substantial shareholding. The definition of non-independence in relation to substantial shareholding in China is that a director holding more than 5% or being one of the five largest shareholders of the listed company is non-independent. The UK *Combined Code* adopts a more flexible term of "significant shareholder" to describe substantial shareholding.

The dual standard of independence is not pursued in the United States, where independence from management is the sole standard. The *Singapore Corporate Governance Code* requires the chairman of the nomination committee of the board to

[599] The Monetary Authority of Singapore has also supposed the criterion of service period to be incorporated into its current definition of what is an independent director. Gabriel Chen, "MAS tightens governance", Strait Times, 18 May, 2010.

be independent from both management and substantial shareholding, but the other independent directors are not required to meet the dual standard. The dual standard of independence gains supports from surveys conducted in Singapore that shows that 96% of CEOs and company secretaries and 82% of institutional investors were of the view that independent directors should be independent of both management and majority shareholders.[600]

The considerations of the Singapore government are that, first, the interests of substantial shareholders are more often aligned with those of all shareholders of the company; second, directors who are substantial shareholders do not pose principal-agent problems; and third, the pool of talent is possibly limited.[601] If the third reason sounds credible, the other two reasons are not sufficiently convincing. It is difficult to see how, in a listed company with a concentrated shareholding structure, an independent director can be truly independent from the management when he or she is not independent from the controlling shareholder,[602] how the interests of the majority and minority can practically be aligned, and how independence can survive this dilemma.

d. Catch-all provision

In addition to the examples specified, the discretion to determine the exact

[600] See "Corporate Governance and Directors' and Officers' Liability Survey of Listed Companies in Singapore 2005, Conducted by the Corporate Governance and Financial Reporting Centre of the Business School, National University of Singapore, and commissioned by Jardine Lloyd Thompson Private Limited; and see "Corporate Governance Survey of Institutional Investors 2005, conducted by Pricewaterhouse Coopers, Investment Management Association of Singapore and Corporate Governance and Financial Reporting Centre of the Business School, National University of Singapore.

[601] See Singapore Ministry of Finance's Comments on the Revised Code, 11 July 2005.

[602] See Michelle Quah, "New Governance Code a Disappointment", *The Business Times*, 18 July 2005.

standard of non-independence is left to companies and the CSRC in China, to companies in Singapore, and to the board of directors in the United Kingdom and United States.

e. Summary

The examples of the non-independence of independent directors are similar across the four countries studied. However, the meaning of independence is different. China has gone a step further to consider the influence of substantial shareholding in addition to that of management, probably because the controlling shareholder has a dominant role in a large number of State-held listed companies.

Table 5.2 Definition of Independent Director

China (2001)[603]	Singapore (2005)[604]	UK (2003)[605]	US (2002)[606]
Requirements: 1.Having basic knowledge on the operation of public listed companies and familiar with the relevant laws and regulations; 2. Having more than five years' work experience in law, economics or other fields. **Examples of non-independence:** 1. Holding a position in a public listed company or its affiliated enterprises, immediate family members, and major social relations. 2. Holding more than 1% of the outstanding shares of a public	**Examples of non-independence:** 1. Being employed by the company or any of its related companies for the current or any of the past three financial years. 2. Having an immediate family member who is, or has been in any of the past three financial years, employed by the company or any of its related companies as a senior executive officer whose remuneration is determined by the remuneration committee. 3. A director, or an immediate family member, accepting any compensation from the company or any of its subsidiaries other	**Examples of non-independence:** 1. Having been an employee of the company or group within the last five years. 2. Having, or having had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director, or senior employee of a body that has such a relationship with the company. 3. Having received or receiving additional remuneration from the company apart from a director's fee, participating in	**Examples of non-independence:** 1. Being an employee, or whose immediate family member is an executive officer, of the company (not independent until three years after the end of such employment relationship). 2. Receiving, or whose immediate family member receives, more than $100,000 per year in direct compensation from a public listed company, other than directors and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is

603 *Supra* Note 11, Art.2 and3.
604 *Supra* Note 469, Guidelines 2.1, 2.2.
605 *Supra* Note 468, A.3.1.
606 *Supra* Note 113, Sec.301; *Supra* Note 598, 303A.02.

listed company directly or indirectly, or the natural person shareholders of the 10 largest shareholders of the public listed company, or being an immediate family member of such a shareholder. 3. Holding a position in a company that holds more than 5% of the outstanding shares of a public listed company directly or indirectly, or of the company that ranks as one of the five largest shareholders of a public listed company, or being an immediate family member of such an employee. 4. Providing financial, legal or consulting services to a public listed company or its subsidiaries. **Catch-all provisions:** 1. Any other qualifications decided by the articles of association; and 2. Any other qualifications decided	than as compensation for board service for the current or immediate past financial year. 4. A director, or an immediate family member, who is a substantial shareholder of or a partner in (with 5% or more stake), or an executive officer of, or a director of any for-profit business organization to which the company or any of its subsidiaries made, or from which the company or any of its subsidiaries received, significant payments in the current or immediate past financial year. As a guide, payments aggregated over any financial year in excess of S$200,000 should generally be deemed significant. **Catch-all provisions:** If the company wishes, in spite of the existence of one or more of these relationships, to consider the director as independent, it	the company's share option or a performance-related pay scheme, or being a member of the company's pension scheme. 4. Having close family ties with any of the company's advisers, directors, or senior employees. 5. Holding cross-directorships or having significant links with other directors through involvement in other companies or bodies. 6. Representing a significant shareholder. 7. Having served on the board for more than nine years from the date of their first election. **Catch-all provisions:** The board should state its reasons if it determines that a director is independent,	not contingent in any way on continued service) (not independent until three years after he or she ceases to receive more than $100,000 per year in such compensation). 3. Being affiliated with or employed by, or whose immediate family member is affiliated with or employed in a professional capacity by, a present or former internal or external auditor of the company (not "independent" until three years after the end of the affiliation or the employment or auditing relationship). 4. Being employed, or whose immediate family member is employed, as an executive officer of another company where any of the public listed company's present executives serve on that company's compensation committee (not "independent" until three years after the end of such service or

by the CSRC.	should disclose in full the nature of the director's relationship and bear responsibility for explaining why he or she should be considered independent.	notwithstanding the existence of relationships or circumstances which may appear relevant to its determination.	the employment relationship). 5. Being an executive officer or an employee, or whose immediate family member is an executive officer, of a company that makes payments to, or receives payments from, the public listed company for property or services in an amount which, in any single fiscal year, exceeds the greater of $1 million, or 2% of such other company's consolidated gross revenues (not "independent" until three years after falling below such threshold). **Catch-all provisions:** The board of directors affirmatively determines that the director has no material relationship with the public listed company (either directly or indirectly as a partner, shareholder or officer of an organization that has a

			relationship with the company). Companies must identify which directors are independent and disclose the basis for that determination. **Special criteria for audit committee members: who may not:** (i) Accept any consulting, advisory, or other compensatory fee from the issuer; or (ii) Be an affiliated person of the issuer or any subsidiary.

(B) Composition of Board and independent directors

a. Comparison

Table 5.3 shows the minimum number of independent directors on the boards of listed companies. The lowest is one third in China and Singapore, and the highest is majority in the USA. For UK public listed companies, at least half of the board, excluding the chairman of board, must be independent. The UK *Combined Code* advocates having a senior independent director who acts as an appropriate channel for shareholders to communicate with the board. The board of directors in Chinese listed companies is obliged to have at least one independent director from an accounting background.

b. Summary

In China, independent directorship has become mandatory since 2002. The one-third proportion of independent directors on the board is still under review of the CSRC. The expertise of an accounting professional is considered beneficial for the corporate governance of listed companies.

Table 5.3 Composition of Board and Independent Directors

China (2001)[607]	Singapore (2005)[608]	UK (2003)[609]	US (2002)[610]
Proportion: At least one third of the board must be independent. **Expertise:** At least one of the independent directors should be an accounting professional.	**Proportion:** At least one third of the board must be independent.	**Proportion:** General companies: At least half the board, **excluding the chairman**, must be independent. Smaller companies (Below the FTSE 350 throughout the year immediately before the reporting year): should have at least two independent directors. **Senior independent director:** The board should appoint one of the independent directors to be a senior independent director.	**Proportion:** At least a majority of the board must be independent directors.

607 *Supra* Note 11, Art.1(3).
608 *Supra* Note 469, Guidelines 2.1.
609 *Supra* Note 468, A.3.2, A.3.3.
610 *Supra* Note 598, 303A.01.

		The senior independent director should be available to shareholders if they have concerns that contact through the normal channels of chairman, chief executive or finance director has failed to resolve.	

(C) Composition of board committees and independent directors

a. Composition

Table 5.4 shows that the majority of board committees must be independent in both China and Singapore. The Singapore *Code of Corporate Governance* makes it clear that the majority should include the chairman of the committee. In the United Kingdom, nomination committees must have at least a majority of independent directors, whereas all of the members of remuneration and audit committees must be independent. In US listed companies, the nomination committee, compensation committee, and audit committee must be composed entirely of independent directors. At least one, two, and all members of the audit committee in Chinese, Singaporean and US public listed companies, respectively, must have accounting or financial expertise.

b. Summary

In China, the board of directors of a public listed company may set up a variety of board committees in relation to nomination, remuneration, auditing, and other reserved matters.[611] As at 31 December 2004, around 47% percent of listed companies had established board committees.[612] In practice, the effectiveness of these committees is subject to the influence of the controlling shareholder over management, the knowledge of independent directors, and the execution of the committee's decisions.[613]

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611 *Supra* Note 163, Art. 52,

612 *Supra* Note 292. The statistics from the report show that as at 31 December 2004, audit committee, remuneration committee, nomination committee, strategy committee has been set up in 48.3%, 52.8%, 42.8%, 47.7% respectively of all companies listed on the Shanghai Stock Exchange.

613 *Ibid.* at 152.

Table 5.4 Composition Board Committees and Independent Directors

China (2002)[614]	Singapore (2005)[615]	UK (2003)[616]	US (2002)[617]
All committees **Quorum:** No requirement **Proportion:** Majority of the committee **Committee chairman:** Independent director **Expertise:** At least one of the independent directors on the Audit Committee should be an accounting professional.	**1. Nomination committee** **Quorum:** At least three directors **Proportion:** The majority of the committee, **including the chairman**, must be independent. **2. Remuneration committee** **Quorum:** Entirely composed of non-executive directors **Proportion:** The majority of the committee, **including the chairman**, must be independent. **3. Audit committee** **Quorum:** At least three directors,	**1. Nomination committee** **Quorum:** No requirement **Proportion:** The majority of the committee, **including the chairman**, must be independent. **2. Remuneration committee and Audit committee** **Quorum:** General company: At least three independent directors Smaller company (Below the FTSE 350 throughout the year immediately before the reporting	**All committees:** **Quorum:** No requirement **Proportion: Entirely** **Expertise:** All members of the Audit committee must be financially literate.

[614] *Supra* Note 10, Art.52.

[615] *Supra* Note 469, Guidelines 4.1, 7.1, 11.1, 11.2; Sec.201B of *Companies Act* of Singapore requires all listed companies should have audit committee. The Monetary Authority of Singapore has recently supposed to raise the number of independent directors on the board, the nominating committee and remuneration committee from one third to a majority. Gabriel Chen, "MAS tightens governance", Strait Times, 18 May, 2010.

[616] *Supra* Note 468, A.4.1, B.2.1, C.3.1.

[617] *Supra* Note 113, Sec.301 (Audit Committee); *Supra* Note 598, 303A.04(a) (Nomination committee), 303A.05(a) (Compensation Committee), 303A.07(a) (Audit Committee).

	all non-executive. **Proportion:** The majority of the committee, **including the chairman**, must be independent. **Expertise:** At least two members must have accounting or related financial management expertise.	year): At least two (2008 revised edition allows the chairman of the board to sit on the audit committee as a member but not a chair, provided that he or she was considered independent on appointment). **Proportion:** Entirely composed of independent directors.	

5.2.2 Board of supervisors

A. Historical development

(A) Germany

The First Industrial Revolution in the eighteenth century had profound effects on the social development and lives in Britain and other European countries. In the mid-19th century, Germany was not yet a united country, but was divided into different countries with their own governments, markets, currencies, and armies, which impeded the economic growth of the whole region.[618] Germany tried to advance its development both economically and militarily with neighboring industrialized countries. Accordingly, freedom of economy coupled with political unification was of historical significance for Germany.

In 1871, the Prussian Chief Minister managed unified a number of independent German states into one nation by "iron and blood," and a German Empire was created.[619] The Second Industrial Revolution in the 1850s promoted science and technology, and "technological and economic progress gained momentum"[620] with the development of steam-powered ships, railways, and electronic power. Germany was thus transformed from an agricultural state into an advanced industrial state. From 1870 to 1913, the GDP of Germany increased by an average of 2.9% annually, ranking the country second in the world next to the United States.[621]

The supervisory board was established by the *General German Commercial*

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618 *Supra* Note 51, at 76-7.

619 See also Alan Farmer & Andrina Stiles, *The Unification of Germany (1815-1919) (Access to History)* (3rd Ed.) (Hodder Education, 2007); Dirk Verheyen, *The German Question: A Cultural, Historical, and Geopolitical Exploration* (2nd ed.) (Boulder, Colo.: Westview Press, 1999), at 177-96.

620 *Ibid*. See also Wally Seccombe, *Weathering the Storm: Working-Class Families from the Industrial Revolution to the Fertility Decline* (London; New York: Verso, 1993), at 81-156.

621 Wu Youfa, *The Modern and Contemporary History of Germany* (Wuhan University Press, 2007) (in Chinese), at 15.

Code of 1861 to "replace the state as monitor of the corporation." The constitution of the supervisory board was totally separate from that of the management board so that it could effectively oversee the management.[622]

(B) China

The board of supervisors was introduced by the *1993 PRC Company Law* (Annulled), which required all joint stock limited companies to have a dual board structure. In particular, the commercial banks are required to have at least two outside supervisors on their supervisory board.[623] Such outside supervisors must be independent from the banks for which they work and the majority shareholders of the banks. Outside supervisors have a similar kind of monitoring role to that of independent directors.[624]

Pursuant to the *PRC Company Law*, any joint stock limited company incorporated in China, either listed or non-listed, must establish a board of supervisors. The board of supervisors must comprise at least three persons, including representatives of shareholders and an appropriate percentage of employee representatives, who must account for not less than one third of all supervisors.[625] The board of supervisors must have one chairman, and an optional deputy chairman. The chairman and deputy chairman must be elected by more than half of all supervisors. The chairman of the board of supervisors must convene and preside over the meetings of the board of supervisors. No director or senior manager may concurrently act as a supervisor.

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[622] Katharina Pistor *et al.*, "The Evolution of Corporate Law: A Cross-Country Comparison" (2002) 23 U. Pa. J. Int'l Econ. L. 791, at 816.
[623] *Guidelines of Corporate governance of Commercial Bank*, issued by the People's Bank of China in June 2002, Article 59,
[624] *Ibid.* Article 60.
[625] *Supra* Note 4, Sec. 118.

B. Comparative research

The supervisory board system was transplanted to China from Germany,[626] where a two-tier board system was made compulsory in 1870[627] and has been a part of German stock corporations for more than a century. A comparative overview of supervisors, supervisory board, and co-determination in Germany and China is given in Tables 5.5, 5.6, and 5.7.

(A) Comparison of supervisors in Germany and China (Table 5.5)

a. Qualification

In Germany, supervisors are not allowed to serve on the management board at the same time. In some circumstances, a person is not eligible to be a supervisor if he or she is the legal representative of one of the company's subsidiaries. Furthermore, the *German Corporate Governance Code* requires a company to have independent members within the supervisory board. However, in China, there are no legal requirements for the qualification of supervisors. In practice, department heads and chairmen of the trade union in state-held listed companies are often appointed as supervisors.[628] The position of supervisors in business operations is inferior to that of directors.

b. Duties

The *PRC Company Law* provides for the duty of loyalty and duty of diligence

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[626] *German Stock Corporations Act* (*Aktiengesetz*) (hereinafter "*German Act*", September 6, 1965 (Legal Gazette I 1089), as last amended by the Act of 28 Oct 1994 (Federal Legal Gazette I 3210). The corporate governance in Germany in this thesis is based on *the German Act* and *German Code*.

[627] Jean J. Du Plessis & Otti Sandrock, "The Rise and Fall of Supervisory Codetermination in Germany" (2005) 16(2) International Company and Commercial Law Review 67, at 71.

[628] *Supra* Note 26, at 12.

only in general terms, and leaves it to judges to develop the rules in judicial cases. In Germany, if a member of the supervisory board is absent from more than half of all the meetings of the supervisory board held within a financial year, this must be specifically noted down in the report of the supervisory board. With respect to the duty of loyalty, both China and Germany set out similar procedural requirements to disclose conflicts of interest.

c. Removal

In Germany, an incompetent or non-eligible supervisor can be removed at a shareholders' meeting by three quarters of the votes with or without cause, or by court order upon application. In China, removal is commonly passed by an ordinary resolution at a general meeting, unless otherwise provided for in the articles of company.

Table 5.5 Comparison of supervisors in Germany and China

Comparison	German	China
Qualification	1. A supervisor is not allowed to serve on the management board at the same time.[629] 2. A person is not qualified to be a supervisor if he or she is the legal representative of one of the company's subsidiaries; or where one of the supervisors of Company A is the director of Company B, the legal representative of Company A is not allowed to be the supervisor of Company B.[630]	The qualification is not specified by law (except the independence requirement for the outside supervisors of commercial banks)
Duty of diligence	1. Every member of the supervisory board must take care that he or she	Yes (same as that of directors)

[629] *Supra* Note 626, Sec. 105(1).
[630] *Ibid*. Sec.100(2).

	has sufficient time to perform his or her mandate.[631]	
	2. If a member of the supervisory board took part in less than half of the meetings of the supervisory board in a financial year, then this shall be noted down in the report of the supervisory board.[632]	N/A
Fiduciary duty/Duty of loyalty	1. All members of the supervisory board are bound by the enterprise's best interests. No member of the supervisory board may pursue personal interests in his or her decisions or use business opportunities intended for the enterprise for himself or herself. 2. Each member of the supervisory board must inform the board of any conflicts of interest. 3. The supervisory board shall disclose in its report to the general meeting any conflicts of interest that have occurred. Material conflicts of interest shall result in the termination of his or her mandate.[633]	Yes (Same as that of directors)
Independent member	The supervisory board must include what it considers to be an adequate number of independent members. A supervisory board member is considered independent if he or she has no business or personal relations with the company or its management board that cause a conflict of interests. Not more than two former members of the management board shall be members of the supervisory board and supervisory board	Commercial banks are required to have at least two outside supervisors

631 *Supra* Note 544, §5.4.5; *Supra* Note 626, Sec.116, 339 and 400. The requirement of duty of care and diligence for supervisors is the same as that of directors.
632 *Supra* Note 544, §5.4.8.
633 *Ibid*. §5.5.

	members shall not exercise directorships or similar positions or advisory tasks for significant competitors of the enterprise.[634]	
Removal	1. Shareholders' meeting: passed by three quarters of votes with or without cause;[635] or 2. Court: upon application.[636]	Removal is commonly passed by an ordinary resolution at a general meeting, unless otherwise provided for in the articles of company

B. Comparison of supervisory board in Germany and China (Table 5.6)

(A) Germany

In Germany, the supervisory board exercises monitoring functions through actively participating in corporate governance matters by determining the members of the management board and by reviewing the business strategies of the company. Specifically, the supervisory board appoints and dismisses members of the management board, but can delegate its appointment authority to a special committee. The supervisory board also discusses and reviews the compensation of the management board members. The management board regularly coordinates with the supervisory board to discuss current business strategies. In China, in contrast, all of this is carried out by the shareholders (save for the employee representatives of the board of director who are elected by employees if the company opts to have employee representatives on its board), rather than the supervisory board.

(B) Problems in China

The difference in power of supervisors in China and Germany is attributable to

634 *Ibid*. §5.4.2.
635 *Supra* Note 626, Sec. 103(1). Here the difference between supervisor and director is that any director on the management board shall be only revoked by cause but the revocation of supervisor has no such a requirement.
636 *Ibid*. Sec. 103(3).

the structure of the respective two-tier boards. China's two-tier boards are horizontally located under the shareholder's general meeting, whereas German boards are vertically placed, with the management board being located under the supervisory board. The supervisory board in Germany thus has real authority to effectively monitor the management board. In contrast, the horizontal structure in China causes difficulties for supervisors as watchdogs, as they may not be able to obtain timely information because it is not compulsory for the board of directors to report to the supervisory board as in Germany.[637]

Table 5.6 Comparison of Supervisory Boards in Germany and China

Comparison	German	China
Appointment and Dismissal of Management Board Members	The supervisory board appoints and dismisses the members of the management board. The supervisory board can delegate its appointment authority to a special committee.[638]	Shareholders' general meeting and employees severally
Compensation	The supervisory board discusses and regularly reviews the compensation of the management board members.[639]	Shareholders' general meeting
Strategy	The management board should regularly coordinate with the supervisory board to discuss the current business strategy.[640]	Shareholders' general meeting
Report	The management board informs the supervisory board regularly, without delay, of all important issues with regard to business planning, risk management, and compliance. The	Same

[637] See Hopt, Klaus J. & Leyens, Patrick C., "Board Models in Europe - Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy" ECGI Law Working Paper No. 18/2004, available at SSRN: http://ssrn.com/abstract=487944

[638] *Ibid*. Sec.84(1); *Supra* Note 544, §5.1.2..

[639] *Supra* Note 544, §4.2.2.

[640] *Ibid*. §3.2.

	management board points out deviations of the actual business development from previously formulated plans and targets, indicating the reasons.[641] The supervisory board is entitled to inspect the accounts and records of the company.[642]	
Approval	Material transactions that may substantially change the assets or financial situation of the enterprise shall be subject to the approval of supervisory board, [643] unless the management board has approving authority over matters that are passed by three quarters of votes at the shareholders' meeting.[644]	Material transactions are subject to approval at the shareholders' general meeting or board of directors in accordance with the articles of association of the company. Exceptions: 1. With respect to fundamental matters of the company, including capital increment/reduction, the issuance of corporate bonds, assignment, division, change of business form, restructuring, winding-up, or the amendment of constitutional documents, a special resolution shall be passed (with two thirds of the votes owned by all of the participating shareholders).

[641] *Ibid*. §3.4. The "onerous reporting requirements" and "voluminous paperwork" are criticized because they may result in excessive formality and cost enhancement without improving the efficiency of company. See Lauren J. Aste, "Reforming French Corporate Governance: A Return to the Two-tier Board" (1999) 32 Geo. Wash. J. Int'lL.& Econ.1, at 25 and 35.
[642] *Supra* Note 626, Sec. 111(2).
[643] *Supra* Note 544, §3.3.
[644] *Supra* Note 626, Sec. 111(4).

		2. The following matters shall be approved by both an ordinary resolution at a general meeting and by no less than 50% of the votes held by general public shareholders: (1) public offering of shares and convertible bonds or rights issues; (2) asset restructuring, where the total price of the assets purchased exceeds the audited net book value of those assets by no less than 20%; (3) repayment of the shareholders' debt owed to the company by company's shares; (4) overseas listing of any affiliate of the company.[645]
	2. Members of the management board shall not take on sideline business activities unless approved by the supervisory board.[646]	N/A
Committees[647]	The supervisory board can delegate to one or several committees the following activities: devising the strategy of the enterprise, compensation of the members of management board, investments and	N/A

[645] The *Provision on Strengthening the Protection of the Rights and Interests of the General Public Shareholders*, issued by CSRC, with effect from 7 December, 2004

[646] *Supra* Note 626, Sec.88; *Supra* Note 544, §4.3.5.

[647] The establishment of committee is not compulsory, but "comply and explain" approach is adopted.

	financing, and meeting arrangements.[648]	

(C) Comparison of codetermination in Germany and China

a. Germany

Unification in Germany required a suitable economic force to push the then divisive domestic markets together. Banks with universal financing power thus came to play a significant role. The securities market in Germany was inactive mainly due to Germany's traditional reluctance to invest and run risks in the capital market.[649] This made the banks the dominant financing source for corporations, rather than the stock market.

The development of two-tier boards in Germany can be traced back to the foundation of a universal banking system in which the banks were the primary source of company funding. It was the banks that called for the establishment of a dual board system in the latter half of the nineteenth century.[650]

The supervisory board was merely a committee of shareholders until public interests were taken into account and participation was extended to employees.[651] Worker participation found its origins in the German *Works Councils Act of 1920*, and the system was reintroduced after the fall of the dictatorial Third Reich after World War II.[652] Employees and trade unions helped to maintain the dependence on "social

[648] *Supra* Note 544, §5.3.4, §5.3.5.
[649] Franck Chantayan, "An Examination of American and German Corporate Law Norms" (2002) 16 St. John's J. Legal Comment 431, at 449-50.
[650] Janet Dine, "Implications for the United Kingdom of the EC Fifth Directive" (1989) 38 I.C.L.Q. 547, at 547.
[651] See Klaus J. Hopt, "The German Two-tier Board: Experience, Theories, Reforms", in *Comparative Corporate Governance: The State of the Art and Emerging Research* (edited by KJ Hopt, *et al*.) (Oxford, Clarendon Press, 1998), at 230.
[652] *Ibid.*

democracy" in Germany. The supervisory board system and concept of codetermination developed separately, but were later coupled to form an integrated system of the two-tier board.[653]

The codetermination structure, which requires an employee in the composition of supervisory board, reflects the "social democracy" of the German corporate governance system. [654] Codetermination can be traced back to the *Works Council Act of 1920* after the German Revolution of 1918.[655] After further developed since the end of the Third Reich,[656] the employee representation is now regarded as the most important characteristic of the two-tier board.[657]

In Germany, how employee representation is applied depends on the industry type, business form, and number of employees in the corporation.[658] The *Mining Iron and Steel Industry Codetermination Act of 1951* requires the boards of companies in the mining, iron, and steel industries to be composed of representatives of employees.[659] Companies outside of these three industries are regulated by the *Codetermination Act of 1976*.[660] The *German Corporate Governance Code* sets out the statutory regulations for German public listed companies. The members of the supervisory board are to be elected by shareholders at the general meeting. In companies with more than 500 or 2,000 employees, employees must be represented on the supervisory board at a ratio of one third or one half, respectively. In companies with more than 2,000 employees, the chairman of the supervisory board, who shall be

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653 *Supra* Note 51, at 123.
654 *Supra* Note 583, at 567-8.
655 T. Raiser, "The Theory of Enterprise Law in the Federal Republic of Germany" 1988 American Journal of Comparative Law 111, at 117; See also *supra* Note 505, at 68.
656 *Ibid.*
657 *Supra* Note 85, at 326; See also *supra* Note 627, at 78.
658 *Supra* Note 627, at 71.
659 *Supra* Note 655, at 115.
660 *Ibid.* at 116.

the representative of the shareholders, has the casting vote in the case of split resolutions. Representatives elected by shareholders and employees are equally obliged to act in the enterprise's best interests.[661]

Codetermination may help to flag up signals of social conflicts between the management and labor earlier and to keep a balance of interests in the supervisory board.[662] However, empirical evidence shows that the functions of codetermination have diminished in two ways: "the catalogue of corporate decisions requiring the consent of the supervisory board has been cut down" and "shareholder representatives on the board do not like to criticize executives whom they regard as their peers in front of trade unionists."[663]

b. Problems in China

The requirements of the *PRC Company Law* for employee representation on the two boards are different. A two-tier board structure with employee representation on the supervisory board is mandatory for all public listed companies, but it is optional for the board of directors to have employee members.[664] Representatives of employees on the board of supervisors must account for no less than one third of all

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[661] *Supra* Note 544.

[662] *Supra* Note 637, at 7.

[663] Ulrich Schroder & Alexander Schrader, "The changing role of banks and corporate governance in Germany: evolution towards the market?" in (Stanley W. Black & Mathias Moersch edited), *Competition and Convergence in Financial Markets: the German and Anglo-American Models* (Oxford; Portland: Hart Pub., 2006), at 23.

[664] *Supra* Note 4, Sec.109. Since 2006, some of the solely State-funded companies are required to have at least one employee representative on the board of directors. The representative shall be elected from the employees and approved by the SASAC. As at June 2008, there are 17 solely State-funded companies which are the "pilot enterprise" to have employee representative on their boards. See the *Provisions of Reinforcing and Improving the Supervisory Board of State-owned Enterprises*, issued by the SASAC, with effect from 28 September, 2006.

supervisors.[665]

(a) Non-compliance with the law

The Shanghai Stock Exchange conducted a survey of 135 public listed companies in 2007 and found that 77% of companies had no employee representatives on their board of directors. Worse still, in 59.2% of the sample companies, the percentage of representatives of employees on the supervisory board accounted for less than one third of all supervisors.[666] This participation ratio is disappointingly low.

(b) Effect of labor representatives on the power balance

In state-held listed companies, employee representatives may not be able to achieve a power balance on the board. Corporate laws do not confer employee representatives with any specific rights in decision-making or monitoring the activities of either the board of directors or board of supervisors. Further, it is unclear whether, as a supervisor elected from among employees, an employee supervisor should act in the best interests of employees or of the company as a whole or both.

This issue is also related to employee participation in the stakeholder model of corporate governance in state-held listed companies. The controlling shareholder may oversee the management through the supervisory board. However, the employee representatives may be influenced by the trade union, which is controlled by the government. Hence, the interests of employees are aligned with the controlling shareholder, which is the government (or, at least, related to the government). Consequently, the balance of power remains with the representatives of shareholders,

665 *Ibid*. Sec.118.
666 *Supra* Note 47, at 49.

rather than the representatives of employees.[667] In addition, shareholder representatives are likely to suppress the influence of employees, such as holding their own informal meetings to avoid information being disclosed to employee representatives.[668]

5.3 Practical issues arising from state controlled ownership in the two-tier boards of state-held listed companies

The state-held listed companies in China are not well governed under the two-tier board system in which the state is the controlling shareholder for two reasons. The first is the conflict of authority between independent directors and supervisors, which renders the presence of the supervisory board redundant. The second is that independent directors cannot perform their third role in China of protecting minority shareholders because the nomination, remuneration, and evaluation are influenced and controlled by controlling shareholders.

5.3.1 Need for independent directors in the presence of board of supervisors

It has been a mandatory requirement in listed companies in China to have an independent director on the board of directors since 2002. However, it must be questioned why an independent director is needed in the presence of a supervisory board. There are two plausible reasons. The first is the internal problems of the supervisory board and co-determination in China, which have been discussed in contrast to Germany. The other reason is that the responsibilities of the supervisory board are taken on by independent directors or the audit committee.

In this part, the focus is on the second reason. A general comparison is first made

667 *Supra* Note 583, at 568.
668 This problem exists in the context of Germany as well. See *supra* Note 2, at 53.

between independent directors and board of supervisors, and their respective authority is distinguished to reveal the unique advantages of independent directors compared with board of supervisors, where appropriate, in the context of China. The independent director's replacement of the supervisory board as the sole watchdog may be seen as a solution, but may also pose risks in state-held listed companies. First, independent directors may not be independent from the controlling shareholders and may thus fail to protect minorities, and second, they may not be able to fulfill their duties.

A. Comparative research between independent directors and supervisors

In Chinese public listed companies, independent directors and supervisors are distinguished in respect of qualification, nomination, and election, but have the same duties of loyalty and diligence as non-independent directors. They also have some legal rights in common. A comparison is presented in the Table 5.7.

(A) Qualification

In China, the independence requirements (discussed in section 5.2.1 of this chapter) are provided by the *ID Guideline*. They include having basic knowledge of the operation of public listed companies and more than five years' work experience in law, economics, or another field. The services provided by independent directors must not have any relationship with or be carried out in circumstances that may affect their independence. There is no legal requirement for the qualification of supervisors.

(B) Nomination and election

The board of directors, board of supervisors, and shareholders individually or

jointly holding more than 1% of shares have the right to nominate independent directors under the *PRC Company Law*. The election of independent directors is passed by ordinary resolution at a general meeting, unless otherwise set out by the articles of the companies. Supervisors are nominated and elected severally at the shareholders' general meeting and employees' meeting.

(C) Common duties

The *PRC Company Law* provides that both independent directors and supervisors have duties of loyalty and diligence.[669] All of the directors and supervisors of listed companies are subject to derivative action and personal action. The duties of loyalty and diligence between independent directors and supervisors are not expressly distinguished by law.

(D) Common rights

Both independent directors and supervisors act as watchdogs to oversee the business and financial operation of corporations. They are conferred the same rights by the *PRC Company Law* to call an interim shareholders' meeting and to appoint external auditors.[670]

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[669] For supervisors, there is a balance to be struck between the duty to exercise their powers for the benefit of the company as a whole and their duty to protect the shareholders and employees who elect/appoint them.

[670] The external auditor is one type of gatekeeper, who is a watchdog over the corporate governance and finance. There are two kinds of definitions of gatekeeper in a legal sense. One definition refers to "the outside professionals" who providing "approving, certifying, or verifying" service to investors" initiated by John C. Coffee Jr. The other definition focuses on the "private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers". In this way, the gatekeeper has a certain authority to grant market access. See Erik F. Gerding, "The Next Epidemic: Bubbles and The Growth and Decay of Securities Regulation" (2006) 38 Conn. L. Rev. 393, Note 219; See also Arthur B. Laby, "Symposium of New Models for Securities Law Enforcement, Outsourcing, Compelled Cooperation, and

Table 5.7 Comparison of Independent Directors and Supervisors

Comparison	Independent directors	Supervisors
Qualification	1. Basic knowledge of business and law, and five years of relevant work experience. 2. Independence requirement	No specific qualification (except independence for the outside supervisors of commercial banks)
Nomination	1. Board of directors 2. Board of supervisors 3. Shareholders independently or jointly holding more than 1% of shares[671]	Shareholders' general meeting and employees' meeting severally
Election	Shareholders' general meeting and examination by the CSRC within 15 working days after election[672]	Shareholders' general meeting and employees' meeting severally
Duties	1. Duty of loyalty and duty of care as a director. 2. Subject to derivative action and personal action	
Rights	1. Calling an extraordinary general meeting and making proposals to the board of directors)[673]; 2. Appointment of external auditors.[674]	

B. Conflicts of authority between independent directors and board of supervisors

A high level of trust and low level of conflict between independent directors and supervisors is not easily achieved.[675] The powers of independent directors and Board of supervisors are listed in the Table 5.8.

Gatekeepers: Differentiating Gatekeepers" (2006) 1 Brook J.Corp.Fin & Com.L. 119, at 122-3. See also John C. Coffee, Jr., "Understanding Enron: It's About the Gatekeepers, Stupid" (July 2002) Columbia Law School, Working Paper No.207, at 5. Reinier Kraakman, "Gatekeeper: The Anatomy of A Third Party Enforcement Strategy" (1986) 2 J.L.Econ. & Org. 53, at 53. See also Assaf Hamdani, "Gatekeeper Liability" (2003) 77 S. Cal. L. Rev. 53; Peter B. Oh "Gatekeeping" (2004) 29 J. Corp. L. 735; Ke Steven Wan, "Gatekeeper Liability Versus Regulation of Wrongdoers (2008) 34 Ohio N.U. L. Rev. 483.

671 *Supra* Note 11, Art. 4(1).

672 *Ibid.* Art. 4(3).

673 *Ibid*. Art. 5(1)(3); *Supra* Note 4, Sec. 54(4)/(5).

674 *Ibid*. Art. 5(1)(5); *Supra* Note 4, Sec. 55(2).

675 J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law* **(**Oxford: Clarendon Press; New York: Oxford University Press, 1993), at 229.

Table 5.8 Powers of Independent Directors and Board of Supervisors

Independent Directors[676]	Board of Supervisors[677]
1. Major related-party transactions (referring to transactions that the public listed company intends to conclude with the related party and whose total value exceeds RMB three million or 5% of the company's net assets audited recently) should be approved by the independent directors before being submitted to the board of directors for discussion. Before an independent director makes a judgment, an intermediary agency can be employed to produce an independent financial advisory report that will serve as the basis for the final judgment. 2. Providing an independent opinion on the following matters to the board of directors or at the shareholders' meeting: (1) Nomination, appointment or removal of directors; (2) Appointment or dismissal of senior executives; (3) Remuneration for directors and senior executives; (4) Current or proposed loan borrowed from a public listed company or other fund transfer made by the company's shareholders, actual controllers or affiliated enterprises that exceeds RMB three million or 5% of the company's net assets audited recently, and whether the company has taken effective measures to collect the due amount; (5) Events that the independent director considers to be detrimental to the interests of minority shareholders. 3. Proposing to the board of directors relating to the appointment or removal of external auditors.	1. Checking the financial affairs and auditing of the company. 2. Overseeing the director and senior executive's actions and demanding any director or senior executives to make corrections of conduct which has infringed the interests of the company. 3. Putting forward proposals at shareholders' meetings. 4. Attending board meetings to raise questions or suggestions. 5. Proposing to remove a director or senior executive who has violated the law or resolution made at a shareholders' meeting.

676 *Supra* Note 11, Art. 5(1)(1)/(2)/(4)/(6), Article 6; *Supra* Note 10, Art.46.
677 *Supra* Note 4, Sec.54, 55(1), 120; *Guidelines of Corporate Governance of Securities Company*, Art. 51,

Requirement: Consent of at least half of all independent directors must be obtained if an independent director wishes to exercise the above rights. When more than two independent directors deem the materials of the board meeting inadequate or unclear, they may jointly submit a written request to postpone the board meeting. Consequence: If the foregoing rights cannot be exercised, then the public listed company should disclose to the public the related information as to why the rights of the independent directors cannot be exercised.	

(A) Unique power of independent directors

Independent directors also have unique power (the first item in the left column in Table 5.8) to approve major related-party transactions.

The *Company Law* defines a "related relationship" as a "relationship between the controlling shareholder, director, supervisor, or senior manager of a company and the enterprise directly or indirectly controlled thereby, and any other relationship that may lead to the transfer of any interests of the company,"[678] with the exception of companies controlled by the state, where there is no related relationship simply because their shares are controlled by the state.[679] Both the *Listing Regulation of the Shanghai Stock Exchange*[680] and *Listing Regulation of the Shenzhen Stock Exchange*[681] define related-party transactions as transactions between a public listed company or its subsidiary and a party that has a related relationship with the public listed company. Related-party transactions are not, in and of themselves, illegal.

Empirical study shows that group-controlled listed companies engage in more

678 *Supra* Note 4, Sec. 217.
679 *Ibid*.
680 The *Listing Regulation of Shanghai Stock Exchange* is revised in May 2006.
681 The *Listing Regulation of Shenzhen Stock Exchange* is revised in December 2004.

related-party transactions than their non-group controlled counterparts.[682] Boards of directors can establish special committees to review or approve related-party transactions, but in practice few public listed companies have done so. Table 5.9 shows that only 3.9% of state-held listed companies have set up such a working committee. Independent directors in public listed companies have the right to veto related-party transactions. Table 5.10 shows that in a small proportion of cases (7.7%), independent directors have vetoed related-party transactions involved with illegal company guarantees or occupation of funds by controlling shareholders.

Table 5.9 Survey of Related-Party Transactions in Public Listed Companies by the Shanghai Stock Exchange in 2006[683]

	Companies with a committee dealing with related-party transactions	Companies without a committee dealing with related-party transactions
Complete sample	4.6%	95.4%
State-held listed companies	3.9%	96.1%
Private listed companies	6.7%	93.3%

Table 5.10 Survey of Instances of Veto by Independent Directors regarding Guarantees or the Occupation of Funds by Public Listed Companies by the Shanghai Stock Exchange in 2006[684]

Veto	Yes	No	Other responses
Complete sample	6.5%	58.5%	35.0%
State-held listed companies	7.7%	56.2%	36.1%
Private listed companies	3.3%	64.4%	32.2%

(B) Overlapping powers of independent directors and board of supervisors

Some of the powers of board of supervisors (listed in Items 2-5 in the right

[682] Ming Jian & T. J. Wong, "Earning Management and Tunneling through Related Party Transactions: Evidence from Chinese Corporate Groups" 2003, SSRN working Paper.
[683] *Supra* Note 18, at 62.
[684] *Ibid.* at 63.

column in Table 5.8) overlap that of independent directors (Item 2 (1) and (2) in the left column in Table 5.8) including overseeing the conduct of directors and senior executives, putting forward proposals at shareholders' meetings, attending board meetings and raising questions or suggestions, and proposing to remove a director or senior executive who has violated the law or resolution made a shareholders' meeting.

An independent director has the same rights as a supervisor to make proposals at a general meeting (see Item 3 in the right column in Table 5.8) and to attend the board meetings (Item 4 in the right column in Table 5.8) with voting rights as a director. In particular, to help them to monitor the conduct of directors or top executives, independent directors have the right to provide an independent opinion to the board of the directors or to a shareholders' meeting in respect of the nomination, appointment or removal of directors and senior executives (Item 2 in the left column in Table 5.8).

C. Overlapping powers of board of supervisors and the audit committee

Auditors ensure the authenticity and completeness of financial statements.[685]

[685] As Li Rongrong, Chairman of the SASAC, has concluded, "[H]ad we had a sound internal auditing and risk management system, the incident of China Aviation Oil (Singapore) could have been avoided." The speech of Li Rongrong on the CAO case and internal risk control is available online at: http://www.ethicalcorp.com/content.asp?ContentID=3309. *Ning Guang Xia* is quoted as the "Chinese Enron" by Chinese media. It made up a fictitious client from Germany and issued reports of falsified export and profits, all of which were to manipulate the share price to an extremely high level. The auditors never had any suspicion of the performance of company, whose share price has increased 440% in the previous three years; and the auditors did not conduct any further investigation but only checked those documents provided by the company. The strategy for the auditors to reduce professional risk so that they do not need to plunge themselves into clarifying the genuineness of the documents is: exemption clauses in the engagement letter to waive or limit the liabilities of auditors. See K.W. Ching, Joo-Seng Tan & Chi Ching R.G., *Corporate Governance in East Asia: The Road Ahead: Analysis and Case Studies in China, Hong Kong, Taiwan, Korea, and Japan* (Singapore; New York: Pearson Prentice Hall, 2006), at 101. See also Wang Guocheng, *Case Studies of Corporate Governance: Analysis and Comments* (Economy and Management Publishing House, 2005) (in Chinese), at 123.

The responsibilities of auditors include "examining the company's accounting and internal control systems" and "determining that there are no material errors in the financial statements."[686] The *Caparo* case defines two additional roles of auditors: preventing "the company itself from the consequences of undetected errors or, possibly, wrongdoing;" and ensuring that shareholders "scrutinize the conduct of the company's affairs and . . . exercise their collective powers to reward or control or remove those to whom that conduct has been confided."[687] In reality, accounting standards permit adjustments and the use of assumptions to some extent in financial statements, and this discretion is at the hands of the management.[688] The "independence" of auditing to provide a fair review and reliable opinion of financial statements is held in high regard[689], and Section 201-209 of the *Sarbanes-Oxley Act* emphasizes "audit independence."[690]

The audit committee is usually regarded as the most important board committee,

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[686] Chartered Financial Analyst Institute, *Schweser Study Notes (Vol.3): Financial Statement Analysis*" (Kaplan Publishing, 2008), at 13.

[687] *Caparo Industries plc v. Dickman & Ors* [1990] B.C.C. 164 HL, at 192.

[688] *Supra* Note 686, at 26.

[689] *Ibid.* at 13.

[690] The cost of compliance before the enactment of the *Sarbanes-Oxley Act* was US$91,000 a year per company, while the compliance cost has gone up to US$1.9 million for internal compliance coupled with US$1.6 million for external audit. According to the Washington Times report, none of ten largest new listings globally in 2005 was registered in the USA. The obviously less listings may be caused by the excessively high compliance cost and more strict legal liability of auditors and lawyers by fear of litigation. Some adjustments have been made. For example, in 2007, a new rule was promulgated by the SEC to exempt some foreign companies from complying with the Sarbanes-Oxley auditing requirement: The US trades of the company over a year shall be less than five per cent of their total trades for the year or the company has less than 300 worldwide or US shareholders. As Robert Clark has predicted, a "carefully specified process" shall be set up for further empirical research to make improvements of the current auditing regulatory work. SEC Rule, 12h-6. Derrick A Paulo "New York, we have a problem", Today online, 22 November 2006. See also Michael F. Holt, *The Sarbanes-Oxley Act: Costs, Benefits and Business Impact* **(**Oxford: CIMA Publishing, 2008**)** at 49-50 and at 75-6. Robert Charles Clark, "Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too" (December 5, 2005) Harvard Law and Economics Discussion Paper No. 525, at 44.

because it is involved in the financial reporting of the company, and is located at the "intersection" of auditors, the board of directors, executive managers, and business units.[691] The *Sarbanes-Oxley Act* focuses on the crucial role of the audit committee and regulates the functions of it by three provisions,[692] which should prove a good reference for future corporate regulations.[693]

In China, an audit committee is required in all listed companies. The audit committee of listed companies usually has authority over internal auditing and the appointment or dismissal of external auditors. The working flow of auditing work is displayed in Figure 5.2. A team in the internal auditing division under the general manager is responsible for the routine work of internal auditing, financial reporting, and disclosure.[694] The *Accounting Law* provides that "the person in charge of a company shall be responsible for its accounting work as well as the truthfulness and completeness of the accounting materials."[695] Auditing work is overseen by the audit

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[691] *Supra* Note 474, at 36. See also Frederick D. Lipman, *Corporate Governance Best Practices: Strategies for Public, Private, and Not-For-Profit Organizations* **(**Hoboken, N.J.: Wiley, 2006), at 12.

[692] *Supra* Note 113, Sec.204, 301, 407.

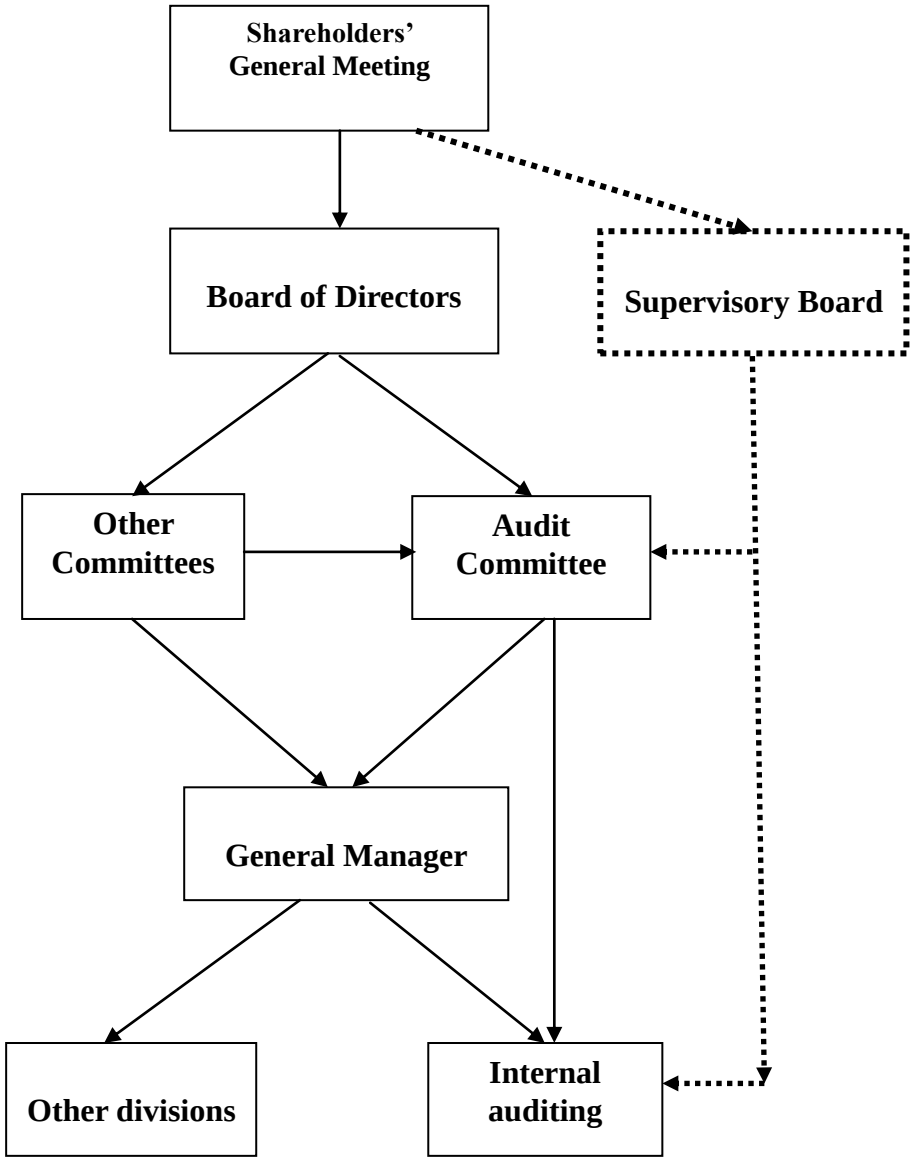
[693] Section 301 provides that the audit committee shall be "directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by the company for the purpose of preparing or issuing an audit report or related work". The public accounting firm shall report to the audit committee. Section 204 enlisted the issues which are required to report, such as "critical accounting policies and practices to be used", "all alternative treatments of financial information", and "other material written communications between the public accounting firm and the management". The audit committee shall have adequate accounting expertise. At least one financial expert member is required by Section 407 of Sarbanes Oxley Act.

[694] The internal auditing is recognized by the OECD to be "an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes". See *supra* Note 210, at 42.

[695] Sec. 4, *PRC Accounting Law*. It is adopted by the Ninth Meeting of the Standing Committee of the Sixth National People's Congress on January 21, 1985; it is revised on December 29, 1993; it is revised again at the 12th Meeting of the Standing Committee of the Ninth People's Congress on October 31, 1999 and promulgated on

committee.

Figure 5.2 Hierarchy of the Internal Organization Structure of Public Listed Companies in China



Under the *PRC Company Law,* the supervisory board is also entitled to monitor the corporate financial affairs and the auditing work of a company (see Item 1 in the

October 31, 1999,

right column in Table 5.8).[696] Hence, the powers of the supervisory board over auditing work overlaps that of the auditing committee. The audit committee, under the board, directly monitors internal auditing and other financial work through the internal auditing division and other related executive teams. However, there is no clarification of the roles and responsibilities of the auditing committee and supervisory board. In practice, most supervisors in state-held listed companies are nominated by the controlling shareholder as the shareholder's representative. Hence, the supervisory board often fails to exercise its authority over auditing work, and the auditing committee is in effect the only authority over the auditors.[697] It is thus unnecessary and redundant (to some extent) to keep this powers with the supervisory board.

5.3.2 Ability of independent directors to protect minority shareholders

A. Role of independent directors

(A) Dual role

All directors have a legal responsibility to manage and monitor corporate business.[698] An independent director is first and foremost a member of the board of directors and participates in the management along with the other directors. Thus, he or she should have the technical competence to contribute to the corporation in a fashion consummate with the size and nature of the business.[699] At the same time, he

[696] See also *supra* Note 664, *Provisions of Reinforcing and Improving the Supervisory Board of State-owned Enterprises*, Art.2-4. See also *supra* Note 26, at 318.
[697] See Yi Longxin, *The Governance Theory of Corporate Finance* (Qing Hua University Press, 2005) (in Chinese), at 225. See also *Collections of Research Paper on Commercial Law* (China Legal Publishing House, 2004) (in Chinese), at 475.
[698] Adrian Cadbury, "Restoring Trust and Confidence in the Corporate System" (1992) 3(12) I.C.C.L.R. 403, at 405.
[699] See Michelle Quah, "How Independent Are They", The Business Times, 9 July 2005.

or she is a non-executive director with integrity, and shoulders the responsibility of ensuring the compliance and accountability of transactions.

A series of reports that constitute the UK *Combined Code* so far emphasize the dual functions of non-executive directors, who "should bring an independent judgment to bear on issues of strategy, performance, resources" (*Cadbury*),[700] "should have both a strategic and a monitoring function" (*Hampel*),[701] and comprise "two principal components: monitoring executive activity and contributing to the development of strategy . . . while there might be a tension, there was no essential contradiction between the monitoring and strategic aspects of the role" (*Higgs*).[702]

Admittedly, the contradictions between independence in relation to business opinion and the inter-dependence of independent director with others on the board is a thorny issue. Their role of principally monitoring rather than managing make them unlikely to "come across valuable business information,"[703] which may undermine the effectiveness of their function of watchdog.[704]

As an independent director, it is not necessary to know the business of the company inside out, but such a director should use his or her expertise and maintain objectivity and above all, independence, to help advance corporate goals and achieve key business objectives. In China, an independent director holds the same level of

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[700] See Cadbury Report (Financial Aspects of Corporate Governance) 1992, §4.11.
[701] See §3.8 of Hampel Report 1998, issued by the Hampel Committee on Corporate Governance in 1998.
[702] See Higgs Report (Review of the Role and Effectiveness of Non-executive Directors) 2003, §6.1 and 6.2.
[703] See Law Commission and Scottish Law Commission, "Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties", joint consultation paper (1999), §3.46. The report is available online at: http://www.open.gov.uk/lawcomm
[704] See Richard C Nolan, "The Legal Control of Directors' Conflicts of Interest in the United Kingdom: Non-executive Directors Following the Higgs Report" (2005) 6 Theoretical Inquiries in Law 413.

legal duties as other directors on the board,[705] and no judicial decision in China has yet clarified the tests to be applied to independent directors and non-independent directors.

The Zhengzhou Baiwen Company Limited ("ZBW"), a then state-held listed company on the Shanghai Stock Exchange, was sanctioned by the CSRC for false disclosure in its listing documents and annual reports in 2001.[706] The case is summarized in Table 5.12. In this benchmark case, the CSRC adopted the same standard for all directors.[707] Mr. Lu Jiahao, one of the independent directors of ZBW, was held liable for the genuineness and completeness of the listed company's listing documents and annual reports. He was sanctioned by the CSRC to pay a fine of RMB 0.1 million, the same amount as the fines meted out to the other directors on the board.

Table 5.12 Case summary of *Zhengzhou Baiwen Company Limited*

Listing information	Listed on the Shanghai Stock Exchange in 1996
Industry	Commercial wholesaling
History	Before listing, it was a state-owned enterprise for the wholesaling of stationery. It was the first public listed company in the city of Zhengzhou.
Reputation[708]	1. Top in the industry of commercial wholesaling. 2. In Top 100 Chinese public listed companies. 3. SOE reform landmark.
First press release after investigation	"False Example and Great Amount Defalcation: Caution from the Fall of Zheng Bai Wen", Xin Hua News Agency, October 30, 2000.

[705] For the duty of care and diligence, the case of *Daniels v. Anderson* distinguishes the extent of duty of care between executive and non-executive directors.

[706] Sources: "False Example and Great loss: the Fall of Zheng Bai Wen", Xin Hua News, 30 October, 2000; Finance and Economics (*Cai Jin*) Issue 8, 2001.

[707] The sanctions were made by the CSRC, Zheng Jian Fa Zi [2001] No.19.

[708] Before the scandal took place, ZBW was a "miracle of stock market" bearing the weight of full confidence of public investors. ZBW is a listed company with "state background": the municipal Zhengzhou government was the largest shareholder of ZBW.

Impugned conduct[709]	A. False listing information: a. False profit-making: RMB 19.08 million (1994 and 1995). b. Insufficiency of raised share capital: only RMB 3.34 million (the minimum shall be RMB 195.62 million). c. Omission in the application materials for IPO to the CSRC and in the Prospectus of the information of 22 branches. B. False disclosure after listing a. False profit-making: RMB 143.9 million. b. Non-disclosure of material investment: RMB 364.46 million. c. False financial statement: non-entry loss: RMB 255.38 million. C. Expropriation of corporate Funds: RMB 200 million. D. Illegal loan from bank (Zhengzhou Branch of Construction Bank): ZBW was both the debtor and guarantor, and the amount of the loan was around RMB 10 billion.
Penalty by the CSRC	Section 74 of *Interim Provisions on the Management of the Issuing and Trading of Stocks 1993*[710]**:** 1. The company: warning and fine of RMB 2 million. 2. Chairman of the Board: fine of RMB 0.3 million. 3. Vice Chairman of Board and General Manager: RMB 0.2 million. 4. Other directors (including independent directors): RMB 0.1 million.
Final result	1. The debt of RMB 1.5 billion owed to the Construction Bank was transferred to Cinda Asset Management Company, one of the four big AMCs. 2. Two options for Cinda: reorganization or application to the court for the bankruptcy of Zheng Bai Wen. 3. The prerequisite condition for reorganization was recapitalization of RMB 600 million from the first big shareholder, the Zhengzhou municipal government, which refused. 4. The bankruptcy application of Zheng Bai Wen filed by Cinda was thrown out by the court due to insufficiency of the documentation for the claim. 5. The debt plus nearly half of the shares of the company were finally transferred to San Lian Group (RMB 300 million), which was then listed accordingly.

[709] The penalty decision was made by the CSRC in 2001.
[710] It is issued by the State Council of China on April 22, 1993.

In the last five years, some independent directors of state-held listed companies have exercised their right to appoint external auditors or propose the investigation of related-party transactions. For example, Mr. Cheng Houbo and Mr. Liu Wenbo, independent directors of Le Shan Electric Power Ltd. ("Le Shan Dian Li", listed on the Shanghai Stock Exchange), challenged the 2003 financial statement of the company by employing the Shenzhen Peng Cheng auditing firm to conduct a special audit of related-party transactions and guarantees between the company and its controlling shareholder in 2004. In another case, four independent directors of Henan Lian Hua Monosodium Glutamate Ltd. ("Lian Hua Wei Jing", listed on the Shanghai Stock Exchange), declared to the press that they had initiated a proposal to the company to investigate fund diversion by controlling shareholders, but their proposal was finally rejected by the company.

It has been reported in the press that most independent directors who have challenged controlling shareholders are eventually dismissed by the listed company after the event. Many independent directors also opt to resign for personal or health reasons for fear of the legal risk of challenging the company in cases in which controlling shareholders have conducted tunneling not yet detected by the authorities.[711]

(B) Third role of independent directors in China

In China, independent directors are conferred a unique third role: that of defending minority shareholders against controlling shareholders, particularly in state-held listed companies. The *ID Guideline* states that although the primary target

[711] See Securities Times, 11 July 2005, available at: http://finance.people.com.cn/GB/1045/3533843.html; see also 21st Century News Report, 16 March 2010, available online: http://tech.sina.com.cn/i/2010-03-16/02383945909.shtml

of independent directors is to protect the overall interests of the company, they "shall be especially concerned with protecting the interests of minority shareholders" and "shall work independently and shall not subject themselves to the influence of the controlling shareholders of state-held listed companies."[712]

The special mission of independent directors to protect the interests of minority shareholders in state-held listed companies in China is a key deviation from the rationale for independent directors in the widely held corporations in the United States. This third role of independent directors is confined to state-held listed companies that have controlling shareholders, but this kind of function is not unique in the context of China. As Arden J. stated in the case *Re Macro Ltd* "given the presence of minority interests, the absence of an independent director world in my judgment be prejudicial to the position of the plaintiffs as shareholders in the companies . . . the desirability of having a truly independent board is applicable to all cases where there are minority shareholders."[713] In view of the dominant power of controlling shareholders in the state-held listed companies in China, the role of independent director to defend the interests of minority shareholders is of great significance.

B. Why independent directors may not be able to protect minority shareholders in China

In state-held listed companies in China, independent directors may not be able to protect minority shareholders because they are not independent from the controlling shareholder. This is due to the internal procedural limitation that the appointment and remuneration of directors is subject to approval at a shareholders' general meeting.

[712] *Supra* Note 11, Art. 1(2). See also Article 2 (1) of the *Provision on Strengthening the Protection of the Rights and Interests of the General Public Shareholders*, issued by CSRC, with effect from 7 December, 2004.
[713] (1994) 2 BCLC 354.

Controlling shareholders have a predominant influence over state-held listed companies in China, and thus the survival of independent directors (whether they are re-appointed and how much they are paid) is in the hands of those shareholders.[714] The centralization of decision power under the administrative hierarchy, influenced by China's planned economy system in earlier times, has affected the internal experience of authority in state-held listed companies.[715] The monitoring role over controlling shareholders assumed by independent directors may not be efficacious, because their interests are firmly linked to the controlling shareholders.

A survey by the Shanghai Stock Exchange reveals that 90% of independent directors in Chinese public listed companies are nominated by the first majority shareholder.[716] According to a survey of 26 independent directors of listed companies covering more than ten industries in nine cities in China, 35% had never issued any independent opinions that went against the views of the controlling shareholders, and 33.3% had never vetoed or abstained from a board decision.[717] The empirical evidence shows that independent directors are not genuinely independent in

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[714] Most of the chairman, deputy chairman and chief financial officer of board of the state-held listed companies are directly decided or approved by the governments before election. Those directors and top executives usually have high-ranking officials in the governments as well as in the Chinese Communist Party at the same time. See Liu Hongxia & Han Yuan, "Governance Risk of Board of Directors in the Chinese Listed Companies" (2007) 6 Contemporary Finance & Economics (in Chinese). See Zhang Duozhong, *The Research on the Controlling System of State-held Companies* (China Economic Publishing House, 2006) (in Chinese), at 144. The Communist Party Committee, employee representative meeting, and trade union, the old three power organs in previous SOEs still exist in the state-held listed companies and their holding companies. The three organs are exerting impacts to some extent on the operation of public listed company, through two-tier shareholdings and two-tier boards. As a consequence, the monitoring functions of independent directors and supervisory board are weakened.

[715] Guthrie, Doug, *Dragon in a Three-piece Suit: The Emergence of Capitalism in China* (Princeton, N.J.: Princeton University Press, 1999).

[716] *Supra* Note 18, at 5.

[717] See the "Report of Independent Director in China" (in Chinese), China Securities News, May 2004.

monitoring the controlling shareholders who have nominated them, let alone protecting minority shareholders.

To sum up this chapter, the two-tier board system is not well governed under the state-controlled model, first because the presence of the supervisory board is redundant as its responsibilities have been taken on by independent directors or the audit committee. Second, independent directors cannot perform their third role in China of protecting minority shareholders because their nomination, remuneration, and evaluation is influenced or controlled by controlling shareholders.

Chapter VI Reflections on the State-Controlled Model

> "The best structure cannot be derived from theory; it must be developed by experience."
>
> Frank H. Easterbrook and Daniel R. Fischel, "The Economic Structure of Corporate Law" (1991)

6.1 Are state-held listed companies in China well governed under the state-controlled model?

6.1.1 Touchstone of a good corporate governance model

Corporate governance consists of transparency, accountability, fairness, and responsibility, which are "put into practice by a combination of regulations, rules, non-legislative codes, best practices, and self regulations,"[718] and should "provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring."[719] The OECD recognizes that "there is no single model of good corporate governance, but there are some common elements underlying good

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[718] Law, Colin & Wong, Patricia, "Corporate Governance: A Comparative Analysis between the UK and China" (2005) 16(9) I.C.C.L.R. 350. Fox & Heller (2006) combine the two perspectives and conclude that good corporate governance shall be defined by looking to the economic functions of the firm rather than to any particular set of national corporate laws. Two elements would be considered: 1. maximization of residuals by managers; 2. pro rata distributions of residuals to shareholders. Defective corporate governance means that a firm does not meet one or both elements of the definition. Residuals are defined as the difference between what a firm pays at contractually predetermined prices to obtain its inputs and what it receives for its output. See generally Fox, Merritt B. & Heller, Michael A. "What is Good Corporate Governance" in *Corporate governance lessons from transition economy reforms* (Edited by Fox, Merritt B. & Heller, Michael A.) (Princeton, N.J.: Princeton University Press, 2006). The authors hold that good corporate governance shall be found in the "economic functions of the firm" instead of from any domestic corporate regulations.

[719] *Supra* Note 390. It asserts that corporate governance involves "a set of relationships between a company's management, its board, its shareholders and other stakeholders". Corporate governance also provides "the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined."

corporate governance." These include an effective corporate governance framework, suitable rights and equitable treatment for shareholders, the role of stakeholders, disclosure and transparency, and the responsibility of the boards.[720]

The corporate governance model for public listed companies has flexible standards depending on the existing institutional framework in each jurisdiction, which does not operate in isolation from the local political and economic circumstances.[721] From the financial perspective, the touchstone of whether a corporate governance model is good or not should be distinguished from the different needs of technical evaluators, such as management performance or investment value.[722] The CLSA report "Saints and Sinners – Who's Got Religion?" (2001)[723] analyzes the results of a survey of 495 companies in 25 emerging markets around the world. The survey questions on corporate governance were divided into seven

[720] *Supra* Note 390, at 13.

[721] Eduardo T. Gonzalez，*Best practices in Asian corporate governance* (Tokyo: Asian Productivity Organization, 2007), at 160. For merit-based system, see also Janis Sarra, "Disclosure as A Public Policy Instrument in Global Capital Markets (2007) 42 Tex. Int'l L.J. 875.

[722] With respect to the management performance, Berghe (1999) points out that "good performance can (temporarily?) mask the detrimental effects of poor management but poor performance often proved to be due to poor governance". See Lutgart van den Berghe, *International Standardisation of Good Corporate Governance: Best Practices for the Board of Directors* **(**Boston: Kluwer Academic, c1999), at 17. An effective governance arrangement should have the positive effects on the performance, notwithstanding the ultimate performance. See the McKinsey Global Investor Survey on Corporate Governance (2002) defines a company with good corporate governance as follows: 1. Owning majority of outside directors, who are truly independent and have no ties with management; 2. Directors have significant shareholding; 3. Material proportion of directors' pay is stock-related; 4. Formal director evaluation is in place; 5. Company is very responsive to investor requests for the information on governance issues. From the perspective of professional investors, good corporate governance may obtain a more attractive image for outside fund raising. See *supra* Note 380; see also International Financial Corporation, "Step by Step, Corporate Governance Model in China: The Experience of the International Financial Corporation" (April 2005), available at http://www.ifc.org/ifcext/home.nsf/Content/Corporate_Governance

[723] *Supra* Note 1. See also the "CLSA Corporate Governance Ratings in Southeast Asia" in ASEAN Roundtable, *Reforming Corporate Governance in Southeast Asia: Economics, Politics, and Regulations* (Singapore, ISEAS, 2005), at 25.

categories: discipline, transparency, independence, accountability, responsibility, fairness (minority shareholder protection), and social awareness. A corporate governance system for public listed companies should consider all seven categories in weighing up their governance practices.[724]

6.1.2 Practical issues of corporate governance in state-held listed companies in China

The following section gives a brief summary of the key points in Chapter IV and V in relation to five practical issues that arise from state controlled ownership under the two-tier shareholding and two-tier board structure of state-held listed companies in China.

A. Three practical issues raised in Chapter IV

As discussed in Chapter IV, in the two-tier shareholding structure where the state is the controlling shareholder, minority shareholders are not well protected for three reasons.

(A) Minority shareholders' interests are infringed upon due to tunneling behavior by controlling shareholders':

There are two types of tunneling: illegal guarantees and the occupation of company funds. It is unsatisfactory that the CSRC officially arranges corrective approaches to illegal fund diversion by controlling shareholders, rather than legally punishing them. In such cases, the controlling shareholder in question is not legally liable as long as he or she is able to repay by the due time.

[724] *Supra* Note 722, *International Financial Corporation*, at 31.

(B) Minority shareholders may not able to effectively exercise their rights to protect themselves under the cumulative voting system

In state-held listed companies, nomination is still under the control of controlling shareholders. In addition, minority shareholders may not have enough votes for their candidates. It is impractical for minority shareholders to elect their nominees under the cumulative voting system, given the controlling shareholder's concentrated ownership in such companies. Minority shareholders are usually public individual investors who have scattered views on the selection of candidates and the business operations of listed companies.

(C) Minority shareholders may not able to effectively exercise their rights to protect themselves by derivative action

Derivative claims made by the minority shareholders of listed companies are rare occurrences in China. Particularly in the case of state-held listed companies, the difficulty for the Chinese courts is not in hearing cases or delivering orders, but in dealing with conflicts of interest between the state (the government as controlling shareholder) and individual (minority shareholders). It is consequently difficult for the courts in China to decide cases that might involve ruling against the government.

B. Two practical issues posed in Chapter V

(A) Independent directors are needed in the presence of board of supervisors

There are two reasons why independent directors are needed in the presence of a supervisory board. First, the internal problems of the supervisory board and co-determination in China affect the effectiveness of the supervisory board's functions. China's two-tier boards are horizontally positioned under the shareholder's general

meeting. The supervisory board in China thus has no real authority to effectively monitor the management board. In terms of co-determination, employee representatives may not be able to achieve a power balance on the board. Corporate laws do not confer employee representatives with any specific rights in the decision-making process or to monitor the activities of the board of directors or board of supervisors. The second reason is that the responsibilities of the supervisory board are taken on by independent directors or the audit committee.

(B) Independent directors are not sufficiently independent from the controlling shareholders to protect minority shareholders

Independent directors may not have sufficient independence to fulfill their duties. In China, an independent director holds the same standard of legal duties as other directors on the board, and no judicial decision in China has yet clarified the tests to be applied to different types of directors. In the last five years, some independent directors of state-held listed companies have exercised their rights to appoint external auditors or ask a listed company to investigate related-party transactions. Most of the directors who challenged controlling shareholders were eventually dismissed by the listed company after the event.

In Chinese public listed companies, the appointment and remuneration of directors are subject to approval at a general meeting. Because controlling shareholders have a predominant influence over state-held listed companies in China, the survival of independent directors (whether they are re-appointed and how much they are paid) is in the hands of controlling shareholders. The monitoring role over controlling shareholders assumed by independent directors may not be efficacious, because their interests are firmly linked to controlling shareholders.

6.1.3 Are state-held listed companies in China well governed under the state-controlled model?

The corporate governance model that China has assumed could not automatically have come into being without relying on the existing institutional framework, and would not independently survive without the circumstances and development in China.[725] Economic development in China is always carefully steered in the desired direction by the central government, backed by heavy political intervention and "close government-business relations."[726] Banking operations and employee activities are still strictly controlled by the Chinese government. For the research in this thesis, the touchstone of whether state-held listed companies in China are well governed under the state-controlled model is whether the practical issues (discussed in Chapters IV and V and summarized in section 6.1.2) can be resolved under the current model.

The practical issues explored in Chapter IV and V are closely related to the controlling shareholder – the Chinese government – under the state-controlled model of corporate governance. A look at the elements of the state-controlled model itself shows that the Chinese government has substantial control over the corporate affairs of state-held listed companies. The bank-based model and the stakeholder model, both of which were connected to state asset management in China during its economic transition from an economy predominated by central planning to an economy driven by market forces with gradual SOE reform.

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[725] "The question is closely related to how the objectives of corporate governance could and should be defined, given one's assessment of the country's social norms and aspirations, and the progress of reform and development in related key areas such as the banking sector, capital markets, social security and welfare position, and regulatory and law enforcement institutions." See *Supra* Note 38, at 39-40.

[726] William D. Greenlee, Jr., "Business Not as Usual in China" (2006) 14 FEB Nev. Law. 10, at 12; See also Randall Peerenboom, "Let One Hundred Flowers Bloom, One Hundred Schools Contend: Debating Rule of Law in China", (2002) 23 Michigan Journal of International Law 471, at 488-90.

Hence, the problems caused by government's heavy involvement and intervention under the two-tier shareholding and two-tier board system in China under the existing governance model prevent the amelioration of the practical issues arising from the specific shareholding and board structure of state-held listed companies. The situation is worsened by (1) the supervisory board working ineffectively; and (2) insufficient independence on the part of independent directors.Thus, state-held listed companies in China are not well governed under the state-controlled model.

6.2 Why the corporate governance of state-held listed companies in China fails to work effectively under the state-controlled model

6.2.1 Issue of enforcement

With the passive involvement of banking and employees, the aforementioned five practical issues are related to enforcement.[727] Without an effective and efficient enforcement system, it is impossible to put any regulatory and governance framework into practice.

A. Is the enforcement of corporate governance transparent?

The answer to this question is in principle affirmative, given the disclosure requirements for listed companies in China. In addition to annual, semi-annual, and

[727] The inadequate legal enforcement is recognized by the *China Corporate Governance Report* (2003) as one of the eight basic problems of public listed companies in China: (1) improper shareholding structure; (2) misplaced government rules; (3) inadequate legal enforcement and legal protection of investors; (4) insider control in corporate affairs; (5) immaturities of the external governance structure; (6) non-guaranteed quality of information disclosure; (7) lack of fiduciary duties and supporting culture environment; (8) weak roles of the media and public. See Shanghai Stock Exchange, *Executive Summary of Shanghai Stock Exchange, China Corporate Governance Report 2003* (Fudan University Press 2003) (in Chinese).

quarterly disclosure requirements,[728] when a major event[729] occurs and such material information may substantially affect the company's stock price, public listed companies should submit an ad hoc report to the CSRC's local authority and the stock exchange, and make an announcement to the general public immediately.[730]

Since 2001, Chinese listed companies have been required to disclose information regarding corporate governance.[731] The information to be disclosed is specified by the *Code of Corporate Governance of Public Listed Companies* to be (i) the composition, performance, and evaluation of the board of directors, of specialized committees, and of the board of supervisors; (ii) the performance of independent directors, including their attendance at board of directors' meetings, their issuance of independent opinions on related-party transactions and on the appointment or removal of directors and senior executives; and (iii) specific action plans to improve corporate governance.[732]

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[728] Pursuant to the *Securities Law*, the information disclosed shall be "authentic, accurate and complete and shall not have any false record, misleading statement or major omission". It is the secretary of board of directors that is in charge of the work of disclosure. The directors, supervisors and senior managers of a listed company shall have the obligation to guarantee the quality of information. The *Securities Law* requires the annual report to be submitted within four months after the end of each accounting year and mid-term report within two months after the end of the first half of each accounting year. The *Administrative Measures For the Disclosure of Information of Public listed companies* further supplements the requirement of submitting the quarterly report within one month after the end of the third and ninth month of each accounting year.

[729] The *Securities Law* enumerates such major events as: any change of business scope, directors, no less than one-third of supervisors or senior executives, holdings of any shareholder (who holds or controls no less than 5% of the company's shares) of the company; any decision of the company on capital reduction, restructure of the company, liquidation or litigation where the company is involved, etc.

[730] *Supra* Note 5, Sec.67.

[731] Shanghai Stock Exchange, *China Corporate Governance Report 2008: Transparency and Information Disclosure* (Fu Dan University Press, 2008) (in Chinese), at 42.

[732] *Supra* Note 10, Art.91.

However, a report of the IFC finds that most Chinese listed companies "are not inclined to go beyond those basic requirements."[733] Listed companies are not actively involved in communication with public investors.[734] To improve the relationship between shareholders and public listed companies and to better protect shareholder rights, the CSRC issued *Working Guidelines for the Relationship between Public listed Companies and Investors*[735] for all the public listed companies to follow. The regulations require information disclosure and communication, including the development strategy of the company, the company's significant investments and changes, the construction of enterprise culture.[736]

The information required to be disclosed gives a basic idea of the development of the company, but the effectiveness of this channel in helping shareholders to understand the company's internal operations is doubtful. This is primarily due to companies' lack of consciousness or activism in their disclosure to investors, especially public minority shareholders. In practice, the contact phone numbers of some public listed companies are not reachable, and inquiries by email are never

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[733] *Supra* Note 722, *International Financial Corporation*.

[734] *Ibid.* In my opinion, merit-based system is more practical for China's corporate governance than comply and explain system, because the merit-based system requires more detailed disclosure so that unwillingness and inactivity of companies may be avoided. The standard of disclosure in such a merit-based system shall be explained more clearly and in greater detail to the public listed companies for practice. For example, a checklist shall be made to ensure the key governance practices be abided by. More importantly, the CSRC should explain the disclosure requirements to help investors to understand the extent of application of law by the public listed companies. See generally Mak Yuen Teen "Improving the Implementation of Corporate Governance Practices in Singapore", written for Monetary Authority of Singapore and Singapore Exchange (June 2007), available at: http:///www.mas.gov.sg/resource/news_room/press_releases/2007/CG_Study%20_Executive_Summary_260607.pdf

[735] It is issued by the China Securities Regulatory Commission, with effect from July 2005.

[736] *Ibid.* Art.6.

answered. In some cases, company officers reply to the inquiries perfunctorily, and merely refer investors to the public bulletin for information.[737]

B. Do the regulatory authorities really work to ensure enforcement?

The CSRC, its local branches, and the two stock exchanges (Shanghai and Shenzhen) are the primary regulatory authorities supervising listed companies in China.

The CSRC was established in 1992 under the State Council to administrate and supervise the national securities market with more than thirty regulatory bureaus (local authority of the CSRC) that cover different geographic regions of the country.[738] The CSRC monitors public listed companies through its local branches, where every supervising official is in charge of five to ten companies. They update information on public listed companies (and especially their governance structure and material related-party transactions).[739] In performing these duties, the CSRC has the authority to take regulatory actions, including conducting investigations without limitation of public listed companies and financial institutions in respect of securities trading and clearing services.[740]

The stock exchange is an operator and frontline regulator that controls the securities-trading business of listed companies and provides services to issuers and intermediaries. Where any normal trading of securities might be disturbed by forthcoming announcements or urgent matters, the stock exchange can call a technical

[737] Lu Zhou, "Close Contact with investor relationship", China Securities News, 24 April 2007.
[738] *Supra* Note 5, Sec.179. The term "CSRC" in this chapter means, collectively, the CSRC itself and the regulatory bureaus.
[739] *Notice of the Local Offices' Work on Overseeing Listed Company*, issued by CSRC in October 2001, Art.2.
[740] *Supra* Note 5, Sec.180.

suspension of trading after reporting to the local authority of the CSRC. The stock exchange can also restrict specific types of trading in the event of possible speculative trading or insider trading.[741]

Approximately 593 contraventions by listed companies were discovered and punished by the CSRC during the period 1996 to 2007.[742] Among these reported cases, 461 (77.74%) concerned information disclosure.[743] Over 50% of the disclosure contraventions resulted from non-compliance with the timeline of the disclosure requirements.[744]

However, such data is not convincing, as it is questionable whether the Chinese authorities would have detected all such misconduct.[745] The CSRC and stock exchanges are "susceptible to political influence and local protectionism," because the punishment and further revelation of unlawful events may "cause a stock market crash"[746] and the ensuing market instability would be likely to result in a substantial loss of state assets owned and controlled by the Chinese governments in state-held listed companies, which would ultimately impede economic growth in China.[747]

6.2.2 Cause of non-enforcement

As identified by North, enforcement is "typically imperfect" because the outcome is decided by functions of the agents who carry out the enforcement.[748]

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741 *Ibid.* Sec.115.
742 Supra Note 731, at 114.
743 *Ibid.*
744 *Ibid.* at 120.
745 Noëlle Trifiro, "China's Financial Reporting Standards: Will Corporate Governance Induce Compliance in Listed Companies?" (2007) 16 Tul. J. Int'l & Comp. L. 271.
746 *Ibid.* at 288-9.
747 *Ibid.*
748 Douglass C. North, *Institutions, Institutional Change, and Economic Performance* **(**Cambridge University Press, 1990), at 54.

Corporate governance in state-held listed companies is not effectively enforced because the sole discretion is exercised by the Chinese governments to arbitrarily interfere in governance practices and the regulation of state-held listed companies.

In the final analysis, the state-controlled model fails to resolve the practical issues because the behavior of the state and business entities is not strictly restrained as a result of non-enforcement of law. On the one hand, the occurrence of corruption results in the non-enforcement law, and on the other hand, non-enforcement reinforces corruption. Consequently, corporate governance in state-held listed companies is trapped in a vicious circle in the long term.

A. Definition of corruption

The generality of corruption is affirmed by Braendle, Gasser, and Noll, who state that "there is no country, which has not been hit by corruption at some point in its history."[749] Corruption is usually defined as the "use of public office to pursue private gain in ways that violate laws and formal rules.[750] It also refers to the act of "a fiduciary person who unlawfully or wrongfully uses his or her station or character to procure some benefit for himself or herself or for another person, contrary to duty and the rights of others."[751] Corruption generally derives from the abuse of power[752] by which the abuser obtains private benefits.

[749] See Braendle, Udo C., Gasser, Tanja & Noll, Juergen, "Corporate Governance in China - Is Economic Growth Potential Hindered by Guanxi?" (April 25, 2005). Available at SSRN: http://ssrn.com/abstract=710203, at 2.

[750] Manion, Melanie, "Corruption and Corruption Control: More of the Same in 1996", China Review (1997), at 33-56. See also Grossman, Herschel I. and Fan, C. Simon Simon, "Incentives and Corruption in Chinese Economic Reform" (March 2000). Available at SSRN: http://ssrn.com/abstract=261701, at 5.

[751] The corruption generally refers to "the arbitrary use of discretionary powers for the personal benefit of oneself and the illegitimate use of public resources". See Brian C. Harms, "Holding Public Officials Accountable in the International Realm: A New Multi-Layered Strategy to Combat Corruption" (2000) 33 Cornell Int'l L.J. 159, at

B. Corruption in China

In China, corruption among government officials generally takes the form of embezzlement ("*Tanwu*"), misappropriation ("*Nuoyong Gongkuan*"), or bribery ("*Shouhui*"), which are respectively provided for by Sec. 383, 384, and 385 of the *Criminal Law*. Embezzlement is distinguished from misappropriation in that in the former case, the official in question takes advantage of his or her position to acquire state property,[753] whereas in the latter case the official misappropriates public property or funds for personal use, but with the intention of returning the property or funds subsequently.[754]

In the course of SOE reform toward privatization, particularly in the case of state-held listed companies, government officials have faced manifold opportunities to misappropriate state assets or accept bribes, after which the misconduct of the company and its officers is hidden.[755] Corruption in China is often a combination of public corruption (government officials) and commercial corruption (business entities).[756]

C. Is corruption being combated in China?

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163 and footnote 16.

[752] Luo Yadong, *Guanxi and Business* (2nd ed.) (New Jersey: World Scientific, 2007), at 213.

[753] *Supra* Note 410, Sec.383.

[754] *Ibid*. Sec.384

[755] Aaron G. Murphy, "The Migratory Patterns of Business in the GlobalVillage" (2005) 2 N.Y.U. J. L. & Bus. 229, at 250.

[756] "Bribery of government officials in China takes many forms, including trips to visit company factories or headquarters with side vacations and entertainment, kickbacks based on a percentage of the sales commission for successfully awarded contracts, overseas education or scholarships for the children of government officials, cash payments to reduce the dutiable value of imports or to expedite customs approval, and fees paid to subsidiaries that then channel the money to government officials." See *supra* Note 750.

As indicated by a survey conducted by the China Reform and Development Research Institute, corruption is ranked first among all factors with an impact on the social stability of China.[757]

The Anti-corruption Bureau (ACB) is the agency that investigates crime that involves taking advantage of duty ("duty-breach crime") by government officials (including, without limitation, embezzlement, misappropriation, and bribery). The ACB works under the procuratorate of every province in China. As per the 2009 report of the Supreme People's Procuratorate of the PRC delivered at the second session of the Eleventh National People's Congress, the ACB had handled 33,546 cases of duty-breach crime and investigated 41,179 persons (including 2,687 officials above the county level) in 2008.[758] Of these cases, 17,594, or over half, were "spectacular cases" involving bribes of more than RMB 50,000 or embezzlement or misappropriation worth more than RMB 100,000.[759] The Central Commission of the Disciplines of the Communist Party of China (CPC) has implemented many inspection programs to monitor party members, and particularly government officials at the national and provincial levels.[760]

Although provincial governments across China have issued over 2000 anti-corruption regulations and policies[761] in addition to the *Criminal Law* and sectoral regulations concerning duty-breach crimes, corruption is still rife and difficult to quantify.[762] The PRC Premier Wen Jiabao admitted in his government work report

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[757] Available online: http://www.ccgov.net.cn/ldwx/chunj05/chunj002.htm

[758] The report is available online at the website of Supreme People's Procuratorate: http://www.spp.gov.cn/site2006/2009-03-17/0002122642.html.

[759] *Ibid*.

[760] *Supra* Note 755, at 249.

[761] Available at: http://www.hbgzw.gov.cn/structure/djyd/llhsjzw_2801_1.htm

[762] John Garnaut, "Economy sets the pace for Beijing's corruption boom", Sydney Morning Herald, 9 January 2010. It adds that "Transparency International's 2009 Corruption Perception Index ranked China 79th of 180 countries, worse than the

that "corruption remains a serious problem in some localities, departments and areas."[763] A number of campaigns have been launched to fight corruption, which have involved the prosecution of "high-profile cases involving high-level officials" but have failed to tackle the widespread low-level incidents of corruption.[764]

D. Why corruption occurs in China

The reasons underlying the presence of corruption in Chinese society are addressed from the historical, economic, and cultural perspectives.

(A) Historical reasons

Hwang (1987) explains the structural factors in Chinese society that contribute to corruption "historically and, to an extent, even in modern contexts, many Chinese have lived in encapsulated communities that are hierarchically organized, with major economic and other resources controlled by a few power[ful] figures who could arbitrarily allocate resources. In these settings, it has been imperative to be sensitive to one's social position and to the kinds of resources that could elicit and be forced to give up through obligations incurred over long periods of time."[765]

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previous year (72nd) and far worse than its 57th place in 2001".

[763] The government work report of China 2008, released on March 5, 2009.

[764] Benjamin van Rooij, "China's War on Graft: Politico-Legal Campaigns against Corruption in China and Their Similarities to the Legal Reactions to Crisis in the U.S." (2005) 14 Pac. Rim L. & Pol'y J. 289, at 289.

[765] Hwang K.K., "Face and Favor: The Chinese Power Game" (1987) 92(4) Am.J.Socio. 944. See also *supra* Note 752, at 21.

In contrast to the individual-oriented liberty of Western society,[766] China has long-standing traditions based on the system of identity in a social hierarchy in feudal society. The first is "*Qin Qin*" ("fidelity to familism and paternalism"), which enshrines the hierarchical pattern of a family based on patriarchy in which fathers or eldest brothers should be respectable and have authority over decision-making. The second is "*Zun Zun*" ("fealty to the emperor"), whereby all citizens swore fealty to the Emperor, who was the son of God ("*Tian Zi*").

Parent-child, husband-wife, elder-younger siblings, Emperor and subordinate, and friend-friend relationships constitute the classic paradigm of the Chinese feudal system. These five basis relationships are called "*Wu Lun*" in Chinese. *Wu Lun* reflects that "hierarchy ordering of familial relations is the principal foundation upon which complex and interlocking human relations in the Chinese society are constructed (the five relationships except for friend-friend are hierarchy relations).[767] Before a person comes into the network of a society, he or she must first be "a proper parent, child, spouse sibling or friend to another,"[768] whereby "*Shangxia Youdeng, Guijian Youbie, and Zhangyou Youxu*" (differences exist between ups and downs, noble and humble, and young and old).

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[766] "The individual is the most important element in a civil society. Everything else must yield to individual liberty". See Charles Lee, *Cowboys and Dragons: Shattering Cultural Myths to Advance Chinese-American Business* **(**Chicago: Dearborn Trade Pub., 2003), at 59. It is argued by Carsten Herrmann-Pillath that "this role of the individual in the indigenous description of social dynamics is overlooked when China is commonly classified as a collective society". See Carsten Herrmann-Pillath, "Social Capital, Chinese Style: Individualism, Relational Collectivism and the Cultural Embeddedness of the Institutions-Performance Link", Frankfurt School of Finance and Management, Witten / Herdecke University, Working paper, No. 132, 2009.

[767] See J.Y. Tan, "Confucianism and Neo-Confucianism" in the *New Catholic Encyclopedia*, (2nd ed.) (Gale Group, 2002), at 95-9.

[768] *Ibid*.

Wu Lun became the standard of conduct, and was increasingly reinforced by successive Emperors for thousands of years.[769] The Emperors maintained a hierarchic system by pushing people to accept *Wu Lun* and respect for traditions, and particularly by encouraging people to "seek guidance in sources other than law," influenced by Confucius.[770]

The hierarchal organization of feudal Chinese society advocated a hierarchal structure between government officials and the common people, or "*Guan Gao Min Di*, *Guan Zhong Min Qing*" (government officials are superior to the common people), which led to the derivation of "*Guan Ben Wei*," or the idea of "prerogatives and privileges going with the position of cadre."[771] The *Guan Ben Wei* takes position as a core measure of a person's social status and value.[772] Hence, the Chinese people's worship and pursuit of power did not disappear with the collapse of the feudal autocratic society, but has spread and continues to strengthen the public's fear of the Chinese government and the motivation to seek positions in the government.[773] Notably, from the perspective of common people in China, possessing power means possessing money (or making wealth) and privileges ("*Sheng Guan Fa Cai*"), and thus corruption prospers in real life and in the minds of people.[774]

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[769] John D. Young, *Confucianism and Christianity: The First Encounter* (Hong Kong University Press , 1983), at 36.
[770] Licht, Amir N., Goldschmidt, Chanan and Schwartz, Shalom H., "Culture Rules: The Foundations of the Rule of Law and Other Norms of Governance" (December 12, 2006). Available at SSRN: http://ssrn.com/abstract=314559, at 10.
[771] See Ronald MacLean Abaroa, "Towards 2005: Profits, People, and the Future of the Regulatory State in the Free Market Model" (1999) 30 Law & Pol'y Int'l Bus. 131, at 135-6.
[772] Jason L. Powell & Ian G. Cook, *New Perspectives on China and Aging* (Nova Publishers, 2007), at 78.
[773] John Wilson Lewis (edited), *Party Leadership and Revolutionary Power in China* (Cambridge University Press, 1970), at 324.
[774] *Supra* Note 772.

(B) Economic reasons

There are also economic reasons that give rise to corruption. If their salary is much lower than that of their peers in business or other professionals, then civil servants are likely to engage in embezzlement or collect bribes from their privileged position, particularly when the expected cost of being caught is low.[775]

The government in China has followed an egalitarian policy of distribution. Compensation is usually composed of two parts: a basic salary (based on a uniform national level and specific regional standards) and a bonus. The egalitarian approach is a product of China's planned economic system, in which resources were limited and the value of labor capital was not recognized.[776] The average level of salary for government officials in China has been low for decades.[777] The low salary system did not become a major factor in increasing corruption when wages in business were lower than in government.[778] However, since the late 1970s when China began to open up to the outside world and carry out economic reform under the policy of "letting a few people be rich first" advocated by Deng Xiaoping, the salary level of Chinese government officials has been well below the average in society.[779] Thus,

[775] "For civil servants, the reward structure within the state administration has traditionally been seen as one of the key determinants in the evolution of corruption. If officials are paid wages comparable to those available to performance, the potential gains from engaging in corruption may not be large enough in relative terms to make it worth the risk. If instead, officials in the public sector are paid wages well below those for similar duties in the private sector, then opportunities for corruption may become the principal reason for choosing a public sector post." See Klitgaard, R., *Controlling Corruption* (University of California Press, 1988).

[776] Chen Wen, *Legal Practices of Stock Options and Corporate Governance* (Law Press China, 2005) (in Chinese), at 133-4.

[777] Luo (2007) summarizes that "China has the largest pool of bureaucrats at various levels in the world, thus creating a heavy burden on the fiscal budget for the central government every year. As a result, the average level of salary for all bureaucrats at various levels has been low for decades". See *supra* Note 752, at 225.

[778] *Ibid*.

[779] *Ibid*. at 225-6.

officials may seek to take advantage of their positions to conduct corruptive behaviors.

To ensure that a remuneration scheme attracts qualified talent into governments and to further combat severe corruption,[780] incentive arrangements have been allowed to be taken into account in an executive's earning package since 1992. An example is an annual salary system that links executive compensation to the company's performance.[781]

Stock options have been voluntarily adopted in some joint stock limited companies since the 1990s,[782] but they are not widely used in listed companies. The regulation governing stock options in public listed companies was issued by the CSRC as *Notice of the China Securities Regulatory Commission on Promulgating the Measures for the Administration of Equity Incentive Plans of Public Listed Companies (For Trial Implementation)* ("*Incentive Notice*"). The *Incentive Notice* limits the scope of persons who are qualified for options, including directors, supervisors, senior executives, and core technicians or business personnel of a listed company, and other employees, but excluding independent directors. The aggregate target stock involved in all of the effective equity incentive plans of a listed company must not exceed 10% of the total company stake. The interval between the date of granting of the stock options and the exercisable date must be no less than one year and no more than 10 years. The equity incentive plan must be drafted by the remuneration committee of the board and passed at a board meeting. All independent directors must present their own independent opinions on the equity incentive plan. Excerpts from the plan, the board resolution, and independent directors' opinions shall

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780 *Supra* Note 210, at 31.
781 *Supra* Note 361, at 40-1.
782 Chen Qingtai & Wu Jinglian (edited), *Research Report of Laws and Policies of Stock Options* (China Finance and Economy Press, 2001) (in Chinese), at 281.

also be disclosed to the public, approved by the CSRC, and passed at a shareholders' meeting by more than two thirds of the voting rights held by shareholders attending the meeting. For state-held listed companies, approval must be given by the SASAC in advance before voting at the shareholders' meeting.[783]

According to a survey in 2006, less than 10% of companies listed on the Shanghai Stock Exchange have adopted stock options as part of their executive compensation systems, and most of those adopting options are privately held.[784] Only 11% of central SOEs have incorporated such incentives into their remuneration schemes.[785] However, stock options are applied as significant instruments for "addressing the agency problem" but may be "part of the agency problem itself."[786]

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[783] Art. 8, 12, 22, 28, 29, 30, 34 and 37.
[784] *Supra* Note 18, at 102.
[785] *Supra* Note 26, at 261.
[786] See Lucian, Arye Bebchuk & Jesse M. Fried, "Executive Compensation as an Agency Problem" (2003) 17 Journal of Economic Perspectives 71. Stock option confers the executives with the right to sell at a pre-specified price the shares they are vested from the company after a pre-specified period of time. There arise disputes over stock options. The dilemma is: options may bring significant incentives to executive's activism for company's performance in order to maintain and further increase the share price of the company so that they may sell the shares they owned at a quite high price; while there is an adverse possibility that the executives who are options holders may run the risk of their stronger motivation: they are eager for ruthless speculation or high-return investment to push the company's share price up. They may prefer to choose business which has more risk but potential pathologies, because there is no real loss for them except for the potential gain if the options become worthless. The reverse effects are recognized by Gordon as a problem that cannot be solved but shall be counterpoised in the tension between incentives and restraints. See Jeffrey N. Gordon, "What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections" (Summer 2002) 69 No.3 University of Chicago Law Review 1. The shift of executive compensation from cash-based to equity-based produces more possibility to lead executives to manipulating earnings, because the use of stock options will probably provide the executive inappropriate incentives to influence their pay and take any measures to raise the stock price of company. See John C. Coffee, Jr. "Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms" (September 2003) Columbia Law School, Working Paper No.237, at 6-7. See also Hans Tjio, "How to Make Corporate Governance Work", NetResearch-Asia: News, 19 March 2002; Jeffrey N. Gordon, "What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections" (Summer 2002) 69 No.3

So far, there is no empirical evidence to prove how stock options and other incentive arrangements for government officials will reduce corruption in China.

(C) Cultural reasons

"Culture" is "an accumulation of experience derived from the adaptive, often partial solutions, to frequently encountered problems of the past" and "becomes deeply imprinted in the minds of people."[787] In a broader sense, the term "culture" is referred to by Thomas L. Friedman as "a product of the context" combined with "geography, education level, leadership, and historical experience."[788] Culture includes the "shared beliefs, attitudes, norms, roles and values [that] worked in the past,"[789] and aims not to "determine peoples' views per se," but to "orient people to process new information in a particular law."[790] The culture of a society reflects a collective ideology commonly recognized by most people.[791]

However, culture is not invariable, but may evolve with internal changes in the "values, beliefs, and views"[792] of new government leaders who steer the development policy of a country, and adaptation to external challenges.[793] Culture may be perceived to induce greater path dependence than other factors,[794] and consequently

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University of Chicago Law Review 1; Teh Hooi Ling "Price of using Stock Options" The Business Times, 24 August, 2002; Brian J. Hall & Kevin J. Murphy, "The Trouble with Stock Options", Havard NOM Research Paper No.03-33.

[787] *Supra* Note 171, at 25.

[788] Thomas L. Friedman, *The World is Flat* (Farrar, Straus and Giroux, 2007), at 425.

[789] Chung, Kim Choy, Holdsworth, David K., Li, Yongqiang & Fam, Kim Shyan, "Chinese 'Little Emperor', Cultural Values and Preferred Communication Sources for University Choice" (2009) 10 (2) Young Consumers 120, available at SSRN: http://ssrn.com/abstract=1460846, at 121.

[790] Andrew K. Woods, "A Behavioral Approach to Human Rights" (2010) 51 Harv. Int'l L.J. 51, at 69.

[791] *Supra* Note 788, at 146.

[792] *Ibid.*, at 147, 243.

[793] *Ibid.*, at 421.

[794] Licht, Amir N., "The Mother of All Path Dependencies: Toward a Cross-Cultural

culture is "considered to be a very powerful impediment to change."[795] The values originating from culture direct the choice of conduct of particular corporations and certain interpersonal institutions,[796] and are a "major determinant of corruption."[797]

a. Legal culture

"Every legal system is built upon some kind of philosophical foundations."[798] China is a state with a long history and a vast territory, with a large accumulation of ideologies, culture, and traditions. The Chinese cultural heritage has grown and evolved through a long history and it is not possible to change it overnight.[799] For example, the May Fourth movement in 1919 was a radical attack, because it "went beyond an empire or a particular dynasty." The revolution targeted but failed to destroy the "ideological underpinnings of the imperial regime, to a system of thought and social organization that had been accepted for centuries and had survived every change in dynasty."[800]

Theory of Corporate Governance Systems" (2001) 26 Delaware Journal of Corporate Law 147, at 150

[795] *Ibid*. at 165.

[796] *Ibid*. at 189. The author states that "Cultural values thus emerge as the 'mother of all path dependencies' in corporate governance systems. The mother metaphor may be useful for pointing out two major implications often associated with path dependence. First, from a hindsight viewpoint, cultural values constitute a heritage of common tastes for certain interpersonal relations and institutions. As a result, they may influence the choice of particular corporate structures and legal rules out of a larger menu. Second, from a forward-looking viewpoint, cultural values are deeply embedded in people's minds and in social institutions. As a result, a corporate governance system that is compatible with social preferences in other areas (most importantly, legal areas) is more likely to work smoothly in a particular society. Additionally, such compatibility may increase the persistence of certain features and impede reforms."

[797] Supra Note770, at 11.

[798] *Supra* Note 788, at 5.

[799] *Ibid.*

[800] Lucien Bianco (translated from the French edition by Muriel Bell), *Origins of the Chinese Revolution, 1915-1949* (Stanford, Calif., Stanford University Press, 1971), at 28.

The traditional Chinese legal culture focuses on the "debate of Confucians v. Legalists" in relation to strategies for managing the state through the more than 2,000-year-old history of Chinese feudal society.

Confucians advocated governing or ruling a nation by "*De*" (morality) and "*Li*" (ritual).[801] The ethics of morality and conduct from rituals were thought to be closer to social ideals. More specifically, rulers should use the inherent obligations of moral ethics to govern society by choosing and appointing the social elite. The premise of the Confucian vision was the existence of "perfect people" who have ideal self-consciousness and self-discipline in a society of righteousness and harmony.[802] The law merely had its "subsidiary function" to support morality and rituals.[803]

In contrast, the legalists denied that "moral influence alone could determine the social order and emphasized the paramount application of explicit laws and sanctions to ensure social stability, in that most people can be persuaded to behave properly only when threatened with harsh punishment."[804] The legalists held that rulers should promote long-standing social stability by the force of law, which had the most exact

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[801] Sheehy, Benedict, "Fundamentally Conflicting Views of the Rule of Law in China and the West & Implications for Commercial Dispute" (August 4, 2005). Available at SSRN: http://ssrn.com/abstract=777087, at 13.

[802] *Supra* Note 770, at 2.

[803] *Supra* Note 749, at 6. See Pat K. Chew, "The Rule of Law: China's Skepticism and the Rule of People" (2005) 20(1) Ohio State Journal on Dispute Resolution 43, at 50. The author argues that "[L]aws are inevitably incomplete and rigid. They must be constantly reviewed and analyzed. The uniformity that is valued by the Legalists is not important; in fact, uniformity can be viewed as unworthy since a particularistic approach that is tailored to unique circumstances better serves societal needs"; Furthermore, the author quoted the words of Confucius that "If the people be led by laws, and uniformity sought to be given them by punishments, they will try to avoid the punishment, but have no sense of shame. If they be led by virtue, and uniformity sought to be given them by *Li*, they will have the sense of shame and moreover will become good".

[804] John W. Head, "Feeling the Stones When Crossing the River: The Rule of Law in China" (2010) 7 Santa Clara J. Int'l L. 25, at 40.

procedures and most effective approaches to control society as a whole in the shortest time.

Both Confucius and the Legalists supported the "rule of man," whereby the Emperor has supreme power above the law despite the existing distinction of the priority of morality or law in ruling the nation. Once one of these two philosophies was adopted by the emperor, it became "state orthodoxy."[805] In history, Legalism was exclusively advocated by the Emperors of the Qin Dynasty.[806] After the Qin Dynasty, Chinese Emperors adopted Confucianism (supplemented by Legalism and other ideologies) into their kingcraft to govern the common people.[807]

Chinese law is one of the oldest legal traditions in the world. In ancient China, with its large territory based on agriculture, the Emperors were always trying to expand the territory to decrease the loss of land caused by natural calamity.[808] Water control, as a prime task, required the nationwide deployment of human and financial resources.[809] All of this required a unitary state power. In the Chinese imperial dynasties that spanned more than 2,000 years, the Emperors were expected to be "virtuous in an exemplary manner."[810] The position of Emperor was not only above

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[805] Liu Changshun, "The Relationship between Water-control and Centralization of Power in China", research report (in Chinese), available at http://www.hwcc.com.cn/newsdisplay/newsdisplay.asp?Id=116903

[806] Albert H.Y. Chen, "Toward a Legal Enlightenment: Discussions In Contemporary China on The Rule of Law" (2000) 17 UCLA Pac. Basin L.J. 125, at 129.

[807] In Chinese history, since the Han Dynasty (B.C. 202 – 220 A.D.), Confucius has been fully applied by Chinese Emperors as basic principle and strategy to govern the nation, while Legalism is also reflected in legal codes, especially in the Tang Dynasty (618 – 907 AD), and the Ming Dynasty (1368 – 1644 A.D.) .

[808] *Supra* Note 805.

[809] Yu the Great (Dà-Yǔ), was the legendary founder of the Xia Dynasty. Occasionally identified as one of the Three Sovereigns and Five Emperors, he is best remembered for teaching the people flood control techniques to tame China's rivers and lakes. Because of his contribution, people call him Dayu in Chinese with "Da" means great. See David E Mungello, *The great encounter of China and the West, 1500-1800* (Lanham, MD: Rowman & Littlefield Publishers, 2009), at 97.

[810] *Supra* Note 806.

all people, but also above the law. The Emperors exercised autocratic control and ultimate authority over legislation, judicature, and administration at their own will.[811]

b. Social culture[812]

The culture of "*Guanxi*" (relationship) is deeply ingrained in Chinese society. The Chinese term *Guanxi* refers to social networking and connections that can be drawn upon to "secure favors in personal relations" and "contains implicit mutual obligations, assurances, and understanding."[813]

(a) Familism

According to ethical values at the household level, traditional Chinese were inclined to solve problems through internal familial regulations or long-existing folk customs.[814] Thus, ancient private business entities, which were similar to the corporation form originating in the West, habitually had familial hallmarks, and were sort of clan businesses organized and managed by family members.[815] China's

[811] *Supra* Note 749, at 6; see also *supra* Note 804, at 43-4.

[812] See Nicolas Meisel, *Governance Culture and Development: A Different Perspective on Corporate Governance* **(**Paris: OECD Development Centre, 2004), at 98-9. Prof. Meisel distinguishes two types of governance models: rule-based and relation-based. The former model relies on "a set of explicit and formal" rules and legal norms for transactions and behavior; The latter recognizes the unique role of implied and informal rules "known by all key players" for "trust, power and information" while this model does not preclude but works simultaneously with the function of legal rules. The relation-based model is typical in East and Southeast Asian nations. Tam (1999) identifies this model as a shift from traditional approach of conformance to a more evaluation on striving for corporate performance "in a future-oriented and outward-looking manner, without denying the need for shareholder protection". *Supra* Note 38, at 33-4.

[813] *Supra* Note 752, at 2, 21 and 215.

[814] Teemu Ruskola, "Conceptualizing Corporations and Kinship: Comparative Law and Development Theory in a Chinese Perspective" (2000) 52 Stan.L.Rev. 1599, at 1600 and1622.

[815] *Ibid*.

inherent "relationship" value is based on lineage and familism, where duty and accountability is adopted for the sake of the family.[816]

(b) Development of *Guanxi* from familism to more complicated relations

"The Specificity of *Guanxi* lies in the synthesis of the emotional and instrumental dimension of social relations."[817] Personal relationships based on kinship can be developed at school, in the work place and through friendship. The *Guanxi* cumulated in social life is widely applied as a shortcut to solve problems in business.[818]

"*La Gaunxi*" means maintaining the social network, or staying on good terms with someone.[819] *Guanxi* may create more flexible chances and capacities within complex political and economic relations.[820] When a *Guanxi*-oriented request is refused, the requesting party will lose "*Mianzi*" (face),[821] and the "*Ren Qing*" (human sentiment or human emotion) underlying the *Guanxi* between the parties ends.[822]

(c) *Guanxi* and corruption

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816 *Supra* Note 685, *K.W. Ching, Joo-Seng Tan & Chi Ching R.G,* at 32.

817 Herrmann-Pillath, Carsten, "Social Capital, Chinese Style: Individualism, Relational Collectivism and the Cultural Embeddedness of the Institutions-Performance Link" (2009) China Economic Journal, Vol. 2(3) 325, at 338-40.

818 *Supra* Note 752, at 5-6. See also *supra* Note 749, at 4; Joel R. Samuels, "Tain't What You Do": Effect of China's Proposed Anti-Monopoly Law on State Owned Enterprises" (2007) 26 Penn St. Int'l L. Rev. 169, at 194-5.

819 *Supra* Note 752, at 12.

820 Supra Pitman B. Potter, "Legal Reform in China: Institutions, Culture, and Selective Adaptation" (2004) 29 Law & Soc. Inquiry 465, at 473.

821 The "*Mian Zi*" means "prestige and honor" of a person. See George O. White III, "Navigating the Cultural Malaise: Foreign Direct Investment Dispute Resolution in the People's Republic of China" (2003) 5 Transactions: Tenn. J. Bus. L. 55, at 58.

822 *Ibid.* at 59.

Guanxi is "one of the major dynamics of Chinese society" and "a key business determinant of a firm's performance,"[823] and thus trust between parties is integral to business development.[824] *Guanxi* is cultivated and maintained by the exchange of gifts and entertainment to establish networks of mutual indebtedness.[825] Such practices are common, and have been "entrenched in the Chinese culture" for a long time.[826]

Gift-giving is an ordinary means of developing *Guanxi*, whereas bribery is viewed as illegal by law. The distinction consists in the underlying motive and objective of the persons giving and accepting the gift.[827] Nevertheless, interpersonal networking based on *Guanxi* has provided "a fertile soil"[828] for corruption in China.[829] Nowadays, numerous business firms in China develop *Guanxi* with government authorities, who have a powerful influence on market activities.[830] The manipulation of *Guanxi* often results in "disparate treatment," and a culture of non-compliance with the law is built up.[831] In a culture of corruption, individuals and

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[823] *Supra* Note 752, at the section of "Preface". Mr. Gao Xiqing, President of China Investment Corporation, addresses at a conference in 2008 held by the OECD reported in the Straits Times, June 28, 2008 by stating that "Our government has never been transparent for 5000 years. Now we are told we need to be transparent and we are trying…We are regular people. We do not have horns growing out of our head."

[824] *Supra* Note 818, *Joel R. Samuels*, at 194-5.

[825] *Supra* Note 755, at 253.

[826] *Supra* Note 175, at 241.

[827] *Supra* Note 752, at 29 and 216.

[828] Some lawyers take use of the relationship and previous background from governments to tout clients. Although it is prohibited by law to declare or imply to potential clients about the relationship, it is still quite common in practice. The *Behavior Criterions for the Practice of Lawyers (for Trial Implementation) 2004* is adopted by China Lawyers Association and comes into effect from March 20, 2004, Art.19.

[829] *Supra* Note 752, at 228.

[830] *Supra* Note 749, at 12; See generally *Supra* Note 752.

[831] Willian P. Alford *et al.* (edited), *Raising the Bar: The Emerging Legal Profession in East Asia* (Cambridge, Mass.: East Asian Studies, Havard Law School, 2005).

entities "feel justified in getting their piece of action by illicit means."[832] Corrupt *Guanxi* and *Guanxi*-based corruption foment "opportunism and dishonorability" in China's economic and social development.[833]

6.3 Could State-held listed companies be well governed in other jurisdictions?

Under the state-controlled model, the Chinese government exercises its control over the corporate governance of state-held listed companies with "substantial discretion."[834] By comparison, state-held listed companies could be just as well managed at arm's length, as in Singapore.

When Singapore gained its independence from Malaysia in 1965, it became a small city state with limited resources and a scant labor force. Singapore has been "shaped [by] its deep sense of vulnerability and the recognition of its dependency on global economy."[835]

The core values of Singaporean culture are "honesty and integrity."[836] The Singapore government has always pursued two imperative strategies: economic growth and national stability.[837] Singapore is always thinking of ways to survive and thrive, but these are founded on a dependence on its disciplined people as the main resource,[838] learning new knowledge and perceptions from others,[839] and taking advantage of its geographical location for external trading.

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[832] Stuart Marc Weiser, "Dealing with Corruption: Effectiveness of Existing Regimes on Doing Business" (1997) 91 Am. Soc'y Int'l L. Proc. 99, at 131; see also *supra* Note 818, *Joel R. Samuels*, at 194-5.
[833] *Supra* Note 752, at 32.
[834] *Supra* Note 34, at 447.
[835] *Supra* Note 171, at 26-7.
[836] *Ibid*. at 151.
[837] *Ibid*. at 87.
[838] *Ibid*. at 151.
[839] *Ibid*. at 15.

Singapore has achieved a "creative synthesis of Western law and Eastern tradition."[840] Singapore is a common law jurisdiction where the conceptions of Confucius are pursued and incorporated as a principal aspect of thought. Singapore adopts a down-to-earth policy in developing its economy, and has ameliorated its legal environment through effective enforcement and transparent governance.

Singapore today is one of the world's freest economies, ranking second in the 2008 index of economic freedom.[841] One of the least corrupt nations in the world according to the Corruption Perceptions Index 2006,[842] corporate governance in Singapore's listed companies has always been top in Asia.[843]

The widespread government linked companies (GLC) of Singapore are well-known for their commercial focus. The Temasek companies are also GLCs, and no less than 20 percent of their stake is held by Temasek Holdings Limited ("Temasek").[844] Temasek, a distinguished investment company since its incorporation in 1974, holds and manages investments that were previously held by the Ministry of Finance of Singapore. In addition to its normal fiduciary duties, the board of directors is accountable to the President of Singapore to ensure that all transactions are made at a fair market value.[845]

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[840] Li-ann Thio "Lex Rex or Rex Lex? Competing Conceptions of the Rule of Law in Singapore" (2002) 20 UCLA Pac. Basin L. J. 1, at 8. The author argues that "[w]hile the Rule of Law is not formally enshrined in the Singapore constitution's text, it has through practice entered Singapore's constitutional and political lexicon", at 1.

[841] The Index covering 10 specific economic freedoms of 162 countries is issued by the Heritage Foundation. It is available at the website of Heritage Foundation: http://www.heritage.org/research/features/index/countries.cfm

[842] The Corruption Perceptions Index is made by the Transparency International.

[843] According to the CLSA 2007, Hong Kong ranks the first, and Singapore ranks the second. Before 2007, Singapore occupied the first place throughout the years.

[844] For example, Temasek holds 21.72% of interest in Keppel Corporation. See Annual Report 2008 of Keppel Corporation, at 230. See also "Temasek Companies vs GLCs: There's a Difference", Business Times, 25 June, 1999.

[845] See "Temasek Review 2009", available at: http://www.temasekholdings.com.sg

Temasek is a non-listed state-held company wholly owned by the Ministry of Finance. This section gives an analysis of the legal framework, objectives, and administration of Temasek in connection with the state assets that it holds compared with the holding companies of state-held listed companies in China, although these hold much greater amounts of state assets (over RMB 10 trillion) and the SOEs (over 100,000)[846] are much more numerous.[847]

6.3.1 Legal framework

Temasek is governed by the Singapore Companies Act and all other applicable laws and regulations in Singapore.[848] In China, the legal framework is more complicated due to the various types of holding companies of state-held listed companies: (1) solely state-funded companies, which are a specific kind of limited liability company under the *PRC Company Law*, are 100% owned by the state, and are authorized by the State Council or the local people's government for supervising state-owned assets; and (2) state-held companies, of which (i) the state or a solely state-funded company is the controlling shareholder or (ii) a solely state-funded company is the ultimate parent company, are incorporated either as limited companies or as joint stock limited companies.

6.3.2 Objectives

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[846] The figure comes from the address of Mr. Li Rongrong, Chairman of the SASAC, reported by the Securities Daily, 30 June 2009.

[847] The portfolio of Temasek Holdings Limited ("Temasek") reaches 172 billion Singapore dollars as at 31 July 2009, available on the website of Temasek: http://www.temasekholdings.com.sg; The portfolio of Government of Singapore Investment Corporation ("GIC") is around 100 billion Singapore dollars, available on the website of GIC: http://www.gic.com.sg.

[848] *Supra* Note 845, at 40.

Temasek is a commercial-mission-driven corporation that aims to "create and maximize long-term shareholder value as an active investor and shareholder of successful enterprise."[849] In China, holding companies of state-held listed companies are concerned with social stability, attracting investment, and maintaining a low unemployment rate, in addition to commercial objectives. In view of the specific national conditions and demand for sustainable development in China, the ultimate target is to balance the strength of various factors, including rural and urban development, economic growth and social justice, internal stability and external relationships, and individual interests and collective achievement.[850]

It is often the "multiple and contradictory objectives" of state ownership that results in "either a very passive conduct of ownership functions" or conversely leads to "the state's excessive intervention in matters or decisions which should be left to the company and its governance organs."[851] The failure to clarify the position of Chinese holding companies of state-held listed companies causes further difficulties in evaluating the performance of the holding companies and their subsidiaries.[852]

6.3.3 Administration

Nowadays, the Singapore government's role in the GLCs is declining, and the GLCs themselves have to hold their own more.[853] As Mr. Lee Hsien Loong, Prime

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[849] The introduction is available on the website of Temasek: http://www.temasekholdings.com.sg

[850] Asian Development Bank concludes that "the PRC Government has adjusted its development strategy to focus on achieving 'five balances' between rural and urban development, interior and coastal development, economic and social development, people and nature, and domestic development and opening to the outside world", ADB report of March 2008, available at the website of ADB: http://www.adb.org/Documents/Fact_sheets/PRC.pdf

[851] *Supra* Note 210, at 23.

[852] *Supra* Note 714, *Zhang Duozhong*, at 113.

[853] "State Support for GLCs on the Decline", The Straits Times, 8 November 2001.

Minister of Singapore, states, "as the economy grows and the private sector expands, the shape of government in business will change. The key is not whether the companies are government owned, but whether they are well-run, entrepreneurial, and profitable."[854]

The Singapore government and the President are not allowed to be involved in business and commercial operations, so Temasek as an state-owned company maintain an independent commercial position. Meanwhile, Temasek does not direct the "commercial or operational decisions of its portfolio companies."[855] Thus, the Singapore government has maintained an arm's-length relationship with the private sector through its government-held corporations, and has no direct control over the corporations, although it is ultimately accountable for them.[856] A reduction in the state's substantial involvement could "reorient the incentives of enterprises towards the market."[857]

In the holding companies of state-held listed companies in China, the governance structure is more complex. It includes CPC committees and trade union committees in addition to the board of directors and board of supervisors.[858] Moreover, these institutions are frequently subject to the involvement of government authorities in business operations and human resources by administrative order.[859] They are directed to achieve short-term goals such as pricing control and meeting export,

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854 "S'pore Inc versus the World", Straits Times, 29 August 2002.
855 *Supra* Note 845, at 41.
856 *Ibid*. It is stated that "Apart from its normal fiduciary duties to the company, our Board is also accountable to the President to ensure that every disposal of investment is transacted at fair market value".
857 *Supra* Note 250.
858 *Supra* Note 714, *Zhang Duozhong*, at 40.
859 *Ibid*. at 41.

employment, or financial targets.[860] These holding companies pass the bureaucratic "spirit" to their state-held listed subsidiaries.

In China, the SASAC under the State Council and related authorized authorities, on behalf of the state, exercise ownership of state-owned assets by performing the investor duties. Based on the principle of the "separation of bureaucracy and business," it is critical to clarify the role of the investor in the administration of state assets as either a regulator or a shareholder. This undertaking requires further theoretical research and empirical work, but the first step is to clearly divide the internal departments within government authorities between investment and regulation, and non-intervention in business operations of state-held listed companies should be exercised.[861]

6.3.4 Summary

As stated in the Temasek Review 2009, "a robust and pragmatic governance framework provides a balance between accountability and responsiveness, between empowerment and organizational alignment, and between risks and returns."[862] The essence of the governance issue is not state-controlled ownership itself, but how the corporate governance of state-held listed companies in China to be regulated by an enforceable legal framework, targeted by defined objectives, and managed with full

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[860] Jean-Claude Maswana, "China's Financial Development and Economic Growth: Exploring the Contradictions" (2008) 19 International Research Journal of Finance Economics 89, at 95. The author recognizes that "although such controls over the price and financial sector may appear a less desirable policy stance, related policies implemented by Chinese authorities have proven effective in ensuring domestic financial stability and external shock immunity".

[861] *Supra* Note 26, at 10 and 106.

[862] *Supra* Note 845, at 40.

operational autonomy.[863] However, such improvements must take place synchronously with political and economic reform.[864]

6.4 How corporate governance in state-held listed companies might work

As has been stated, state-held listed companies in China are not well governed under the state-controlled model, because the practical issues of the weak protection of minority shareholders (Chapter IV) and the failure of the two-tier board structure to perform efficiently (Chapter V) cannot be addressed by the model due to non-enforcement of the law and corruption. It is proposed here that corporate governance in state-controlled listed companies could be made more effective under a "law-controlled model." This model would improve the corporate governance of state-held listed companies by implementing the rule of law in terms of state-held listed companies in China. Failing that, corporate governance could be improved by (i) reforming the law to settle the practical issues; and (ii) enforcing the law to fight against corruption.

6.4.1 Rule of law

A. Theoretical conceptions of the rule of law

Law is one of the most important instruments of social control.[865] The concept of the "rule of law" was put forward by the Greek ideologist Plato and subsequently

[863] *Supra* Note 210, at 24.
[864] *Supra* Note 250, at 20.

Aristotle, who referred to the "obedience to positive law and formal checks and balances on rulers and magistrates."[866] The conceptions of the rule of law in modern times have been widened through clear and stable legislation, effective enforcement, a transparent and independent judiciary, and reasonable acceptance by the general public. In a jurisdiction with a rule of law, "law is able to impose meaningful restraints in the state and individual members" under the supremacy of the law and equality of all before the law.[867] The law is meant to ensure administrative transparency and judicial independence so that the "predictability" and "certainty" of the law is enhanced, government corruption or arbitrariness reduced, and legitimate rights protected.[868]

The rule of law respects fundamental human rights and serves the goal of stability[869] to promote "fairness and equity" and protect "the poor and the weak."[870] However, the realization of the individual's rights is based on secured property ownership and freedom of contract in the legal sense. La Porta *et al.* (1998)[871]

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[865] See Coffee, John Jr., "Do Norms matter? A Cross-Country Examination of the Private Benefits of the Control", Columbia Law School Working Paper, January 2001. Coffee recognizes the social norms, as another social control instrument (independent of any legal sanctions), work to constrain managers and controlling shareholders, but exactly when and how much of such constraints remain unknown. Coffee concludes that "when formal law does not adequately protect shareholders, the strength of social norms becomes more important, because they could provide a functional substitute for law. Conversely, when legal rights and remedies adequately protect investors, there is less need for corporations to signal their intentions to observe standards that are already legally mandated or to develop creative means by which to bond those promises through self-help corporate governance measures".

[866] See Aristotle, *Politics* (University of Chicago Press, 1985); See also Sharma, Sharda Sanjay, "Justice without Power is Inefficient, Power without Justice is Tyranny" (January 19, 2009), available at SSRN: http://ssrn.com/abstract=1329885.

[867] *Supra* Note 726, *Randall Peerenboom*, at 471-2; See also Randall Peerenboom, "Rights and Rule of Law: What's the Relationship?" (2005) 36 Geo. J. Int'l L. 809, at 814-6.

[868] *Supra* Note 726, *Randall Peerenboom*, at 497.

[869] *Ibid*. *Randall Peerenboom*, at 494-7.

[870] *Supra* Note 169, at 557.

[871] *Supra* Note 388.

emphasize the legal system as an external factor in evaluating corporate governance practices. They review the legal rules[872] in 49 countries on the protection of shareholders[873] and creditors[874] and the quality of their enforcement.[875] The results show that "common law countries generally have the strongest, and French-civil-law countries the weakest, legal protection of investors, with German- and Scandinavian-civil law countries located in the middle."[876] Nevertheless, one consideration should be stressed. The standards and level of the rule of law cannot be universal, and can only be roughly compared between jurisdictions.[877] Adam Ferguson's classic affirmation of the establishment of nations is that it is "the result of human action but not the result of human design."[878] This point of view has been

[872] See *ibid*, at 1120. The authors only refer to the laws, pertaining to investor protection of company and bankruptcy/reorganization laws, with no rules on merger and takeover, disclosure, securities exchange, banking and financial institution.

[873] See *ibid*, at 1126-30. The authors divide shareholder rights into two categories: voting rights and remedial rights. Specifically, they are one-share-one-vote rules, anti-director rights (including proxy by mail allowed, shares not blocked before meeting, cumulative voting/proportional representation, oppressed minority, preemptive right to new issues, percentage of share capital to call an extraordinary shareholder meeting), and mandatory dividend right.

[874] See *ibid*, at 1134-35. The authors recognize the two reasons why creditor rights are more complex than shareholder rights. First, different types of creditors with different interests may exist; second, there are two strategies of creditors to deal with a defaulting company: liquidation and reorganization. The authors further divide creditor rights into 5 types: "(i) reorganization procedure imposing an automatic stay on the assets; (ii) secured creditors first paid (before government and workers); (iii) restriction on management for filing for reorganization; (iv) management does not stay in reorganization; (v) legal reserve requirement".

[875] See *ibid*, at 1140. The authors use five enforcement measures: "(i) efficiency of judicial system; (ii) rule of law; (iii) corruption; (iv) risk of expropriation (including outright confiscation or forced nationalization) by the government; (v) likelihood of contract repudiation by the government".

[876] *Ibid*, at 1113

[877] See Randall Peerenboom, "What Have We Learned About Law and Development? Describing, Predicting, and Assessing Legal Reforms in China" (2006) 27 Mich. J. Int'l L. 823, at 842.

[878] Adam Ferguson, *An Essay on the History of Civil Society* (Cambridge University Press, 2007) at 187.

commended by Hayek as the "basis of our understanding not only of economic life but of most truly social phenomena."[879]

B. Is the rule of law put into effect in contemporary China?

(A) Rule by law?

The essential difference between "rule of law" and "rule of man" is that the force of law prevails over that of dictators in the event of any discrepancy or conflict between them in the context of the rule of law. The "rule of man" was a long-standing social system in feudal China, and Emperors were supreme above the law.[880]

Pitman Potter captures the approach of the rule by law as "instrumentalism" as follows.

> "Laws and regulations are intended to be instruments of policy enforcement. Legislative and regulatory enactments are not intended as expressions of immutable general norms that apply consistently in a variety of human endeavors, and neither are they constrained by such norms. Rather, laws and regulations are enacted explicitly to achieve the immediate policy objectives of the regime."[881]

Contemporary China has been a country of "rule by law" since the late 1970s.[882] Since China adopted the Reform and Opening up policy in the late 1970s, the law is

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[879] Hayek, Friedrich A. Von, *Individualism and Economic Order* **(**London: Routledge & K. Paul, 1949), at 7-8.

[880] *Supra* Note 866. Qing (1644-1911A.D.) was the last imperial dynasty in Chinese history. The Chinese historians usually refer to the period from Qin Dynasty (221-206 B.C.) to Qing Dynasty as the imperial or feudal period of China.

[881] Pitman B. Potter, *The Chinese Legal System: Globalization and Local Legal Culture* (New York: Routledge, 2001), at 10. It is also quoted by *supra* Note 804, at 34-5. See further Liang Zhiping, *Rule of Law in China: System, Discourse and Practice* (China University of Political Science and Law Press, 2002) (in Chinese), at 130-1.

[882] The "rule by man" is prevalent in Mao's era when "law was completely eliminated from China" under Mao Zedong's control. Particularly during the periods of "Great Leap Forward" (1958-1961) and "Cultural Revolution" (1966-1976), the pronouncements of Mao "were believed to be the only source of law" when "laws were abolished and all law schools were closed" during the Revolution. See Stephen

utilized by Chinese governments as an instrument of administration.[883] The legal system, as Potter points out, is not "a limit on state power; rather, it is a mechanism by which state power is exercised," because "the legal forms and institutions that comprise the Chinese legal system are established and operate to protect the Party/state's political power."[884] By relying on the law as an instrument for public governance, the "rule by law" has been utilized by political authorities to "serve the interests of the nation" rather than "protect the rights of individuals."[885]

(B) A "thin rule of law"?

Professor Peerenboom divides the theories of the rule of law into two types: thin and thick.[886] A thin rule of law underlines the "formal or instrumental aspects of rule of law—those features that any legal system allegedly must possess to function effectively as a system of laws."[887] In contrast, the thick rule of law starts with the basic elements of the thin conception but then incorporates elements of political and economic arrangements, forms of governments, or conceptions of human rights.[888] It is not uncommon to connect economic development with democracy nowadays, but there is no causational relationship between them two. As Peerenboom points out,

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L. McPherson, "Crossing the River by Feeling the Stones: The Path to Judicial Independence in China**"** (2008) 26 Penn St. Int'l L. Rev. 787, at 792; see also He Weifang, "China's Legal Profession: The Nascence and Growing Pains of a Professionalized Legal Class" (2005) 19 Colum. J. of Asian L. 13; Xin Chunying, "What Kind of Judicial Power Does China Need?" (2003) 1 Int'l J. of Const. L. 58.

[883] See discussion on the difference between "rule of law" and "rule by law", available at: http://www.oycf.org/Perspectives/5_043000/what_is_rule_of_law.htm

[884] *Ibid.*

[885] *Supra* Note 726, *Randall Peerenboom*, at 26.

[886] *Ibid.* at 1-2.

[887] *Ibid.*

[888] *Ibid.*

"although wealth matters, this does not mean there is a particular point at which countries necessarily become democratic."[889]

The constitutive elements of the "thin" rule of law are summarized by Peerenboom as procedural rules, transparency, general and fair applicability, clarity, predictability, consistency, stability, enforcement, and reasonable acceptance by the majority of people affected.[890] The legal system in China is characterized by Peerenboom as "a system that complies with the basic elements of a thin rule of law."[891]

As Wang and Zhang (1997) state, "China is trying to advocate the rules of predictability, calculability and accountability of market operation, principles of freedom and autonomy, considerations of equal value and efficiency, and ideas of democracy and human rights, etc, and further incorporate all of this into current legal system."[892] With increasing consciousness of the law in China, ordinary people have become accustomed to depend on the law to resolve disputes.[893] In the past few decades, a legal system has been established in China with "remarkable progress,"[894] but a thin rule of law has not yet truly been put into effect.

China's legal system still falls short in some elements compared with the minimum standard to achieve the thin rule of law, so China is in transition from rule by law to a thin rule of law.[895] Laws in China have not been well enforced,

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[889] *Supra* Note 160, at 26-28. The author cites the example of Asian countries, such as the Philippines, Indonesia, Cambodia, etc.
[890] *Supra* Note 726, *Randall Peerenboom*, at 477-9.
[891] *Supra* Note 726, *Randall Peerenboom*, at 536.
[892] Wang Chenghuan & Zhang Xianchu, *Introduction to Chinese Law* (Hong Kong: Sweet & Maxwell Asia, 1997), at 27.
[893] See Benjamin L. Liebman, "Assessing China's Legal Reforms" (2009) 23 Colum. J. Asian L. 17, at 20.
[894] *Supra* Note 726, *Randall Peerenboom*.
[895] *Ibid*. See generally Wang Jiangyu, "The Rule of Law in China: A Realistic View of the Jurisprudence, the Impact of the WTO, and the Prospects for Future

particularly in their application to government officials or business entrepreneurs due to political influence.[896] The political challenge in the attainment of a thin rule of law in China is discussed in the next section, but put briefly the law cannot be effectively enforced without taking into account native resources and circumstances, and it takes time for a nation to improve and perfect by steps its legal institutions in the context of its specific social circumstances.[897]

C. Is it possible to give effect to the rule of law in terms of state-held listed companies in China?

(A) Policy

The principle of "governing the country according to law and building a socialist country under rule of law" ("*Yifa Zhiguo, Jianshe Shehui Zhuyi Fazhi Guojia*") was declared to be a long-term state policy for the first time by the then President Jiang Zemin in his keynote address delivered at the 15th National Congress of Communist Party of China in 1997.[898] The rule of law is asserted in the *White Paper on Rule of*

Development" 2004 Sing. J. Legal Stud. 347. See also Statement of William P. Alford to the Congressional-Executive Commission on China Hearing on Human Rights in the Context of the Rule of Law (7 February 2002), available online: http://www.cecc.gov/pages/hearings/020702/alford.php. Professor Alford recognizes that"[O]ver the past quarter century, the PRC has been engaged in the most concerted program of legal construction in world history. At the end of the Cultural Revolution (1966-1976), the PRC's modest legal infrastructure lay in near ruin--with but a skeletal body of legislation, a thinly staffed judicial system, and a populace having scant awareness of law. Today, the PRC has an extensive body of national and sub-national legislation and other legal enactment, concentrated on, but not limited to, economic matters, and has joined major international agreements covering trade, the environment, human rights, intellectual property and a host of other issues".

[896] *Ibid.*

[897] *Ibid.*

[898] Chen Jianfu, *Chinese Law: Towards an Understanding of Chinese Law, its Nature and Development* (The Hague; Boston: Kluwer Law International, 1999), at 361.

Law in China published by the State Council in 2008,[899] and is further provided for in the *Amendment 1999* to the *PRC Constitution.*[900]

More recently, in a report delivered at the 17th National Congress of CPC in 2007 President Hu Jintao cited the rule of law as a "fundamental principle" that constitutes the "essential requirement of socialist democracy." China has practically completed its social transformation from a traditional closed realm to a relatively open market over the past few decades, and the rule of law has been officially recognized by the Chinese government as a significant approach to promote political stability, economic sustainability, and social evolution.

With respect to the rule of law in China, the economic reforms have helped to create positive surroundings for legal reform and demand an effective legal system.[901] State-held listed companies have a unique strategic or monopolistic position in China's economy. The corporate governance reform of state-held listed companies in China is at the intersection of Chinese economic growth and legal modernization. Corporate governance itself has surpassed its pure legal meaning. It is thus necessary to escalate the internal governance practices of state-held listed companies to a broader external institutional context of social circumstances.

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[899] This is the first white paper on the rule of law released on 28 February 2008 by the State Council Information Office of China. The official Chinese text is at: http://www.china.com.cn/policy/fzjs/node_7041734.htm. The English version entitled "China's Efforts and Achievements in Promoting the Rule of Law" is available on the website of the State Council Information Office: http://www.china.org.cn/government/news/2008-02/28/content_11025486.htm

[900] The Amendment was adopted at the Second Session of the Ninth National People's Congress and promulgated for implementation by the Announcement of the National People's Congress on March 15, 1999. A new paragraph is added to Article 5 of the Constitution as the first paragraph, which reads, "[T]he People's Republic of China governs the country according to law and builds a socialist country under rule of law."

[901] Randall Peerenboom, *China Modernizes: Threat to the West or Model for the Rest?* **(**Oxford University Press, 2007), at 198.

(B) Challenges

The policy of promoting the rule of law may more accurately represent the aspirations of Chinese leaders in the transition toward a market-oriented economy, coupled with the underlying political challenges.[902] The law itself may "fail to limit the state power."[903] The gap "between the law on paper and the law in reality" is not closed.[904] The achievement of the rule of law in China is challenged by its tardiness in reaching political maturity compared with its speediness to secure economic growth.

In China, there are no clear lucid lines between "nation" ("*Guojia*"), "government" ("*Zhengfu*"), and "the Communist Party of China" ("*Zhongguo Gong Chan Dang*")[905]: they are often stuck together in both the media and government policies.[906]

The propaganda of the CPC has always declared that "every CPC member is a unselfish public servant of the people,"[907] but the Party itself poses a substantial challenge to the promotion of the rule of law in China.[908] The CPC has been the leading political party since the foundation of People's Republic of China in 1949. The other eight political parties are named "democratic parties" ("*Minzhu Dangpai*"), and participate in and discuss state affairs ("*Canzheng Yizheng*"). The political system

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[902] Pat K. Chew, "The Rule of Law: China's Skepticism and the Rule of People" (2005) 20 Ohio St. J. on Disp. Resol. 43, at 64.

[903] Supra Note 893, at 17. See also Pitman B. Potter, "Legal Reform in China: Institutions, Culture, and Selective Adaption" (2004) 29 Law & Soc. Inquiry 465, at 470: "[D]espite 25 years of ever-increasing interaction between China and the outside world, foreign assessments of the Chinese reform project still reflect extremes of optimism and cynicism".

[904] *Supra* Note 896, *Wang Jiangyu*. See also supra Note 749, at 7.

[905] Benedict Sheehy, "Fundamentally Conflicting Views of the Rule of Law in China and the West & Implications for Commercial Disputes" (2006) 26 Nw. J. Int'l L. & Bus. 225, at 237.

[906] *Ibid*. at 230-2.

[907] *Supra* Note 750, *Grossman, Herschel I. and Fan, C. Simon*, at 9.

[908] *Supra* Note 726, *Randall Peerenboom*, at 495-505.

is expressly defined in the Preamble to the *PRC Constitution* as "the system of multi-party co-operation and political consultation led by the Communist Party of China ("*Duodang Hezuo, Zhengzhi Xieshang Zhidu*"), which is virtually a one-party dictatorship system because the democratic parties are merely entitled to discuss and consult on state affairs and have no power of determination.[909]

The "peculiar entrenchment" of the CPC in the political system renders the law's application to "all segments of the society" impossible[910]: the law has become a "tool" for CPC members to manipulate.[911] For instance, the judiciary is not detached from the CPC and government authority to act independently in accordance with the law based on legal principles and public policies, and judges are often pressured to make decisions that favor the interests of the government.[912]

The essential challenge to the rule of law in China lies in the CPC's one-party dictatorship. Is it possible for the CPC to change its mindset and effect a true rule of law? It will be difficult for the CPC to change because it is reluctant to lose its current arbitrary power and political control.[913]

The adherence to the leadership of the CPC as China's ruling party is one of the fundamental principles of the *PRC Constitution*[914] because "both the victory in China's New Democratic Revolution and the successes in its socialist undertaking have been achieved by the Chinese people of all nationalities, under the leadership of

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[909] *Supra* Note 905, at 237.
[910] *Supra* Note 804, at 83.
[911] *Supra* Note 905, at 226.
[912] *Supra* Note 885, *Stephen L. McPherson,* at 788-9 and 792.
[913] Bradley L. Milkwick, "Feeling for Rocks while Crossing the River: The Gradual Evolution of Chinese Law" (2005) 14 J. Transnat'l L. & Pol'y 289, at 306.
[914] *Supra* Note 227. It is regulated in the Preamble of *Constitution of PRC*. The other fundamental principles include: "adherence to the people's democratic dictatorship, to the socialist road, and to the reform and opening to the outside world".

the Communist Party of China."[915] More importantly, the *PRC Constitution* expressly provides that "the system of the multi-party cooperation and political consultation led by the Communist Party of China will exist and develop for a long time."[916] The ambiguous terminology here makes the timeline for the existence of the one-party system difficult to change quickly.

The CPC's reluctance is reflected in the speech of President Hu Jintao, who is also general secretary of the CPC Central Committee, on the relationship between the concepts of the "Socialist Rule of Law" and the CPC. He states that "the CPC's leadership is the fundamental guarantee of the rule of law, which is the basic strategy for the people running the country under the leadership of CPC. So we shall consciously uphold the CPC's leadership, consolidating the party's ruling status and maintenance of unity of the socialist rule of law."[917]

It is thus impossible, or at least difficult, to give immediate effect to the rule of law in China because the CPC has no political initiative to adjust its supreme role in China's political structure, and has no apparent willingness to give up its overall control.

6.4.2 Reforming the law

A. Overview

Although the rule of law is difficult to effect in China, a "law-controlled model" could improve corporate governance in state-held listed companies by reforming the law.

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915 *Ibid.*

916 *Ibid.*

917 The speech is delivered by President Hu Jintao on the twentieth anniversary of the promulgation of the Constitutional Law, on 4 December 2002. Available at: http://211.144.95.140/pudong/showinfo/showinfo.aspx?infoid=3486&siteid=1&categoryNum=0111

Such legal reform should have two-dimensions: succession from existing sources and transplants from overseas jurisdictions. The modern Chinese legal system has a great diversity of sources, including traditional Chinese laws more than 2,000 years old[918] and foreign laws transplanted from civil law and common law jurisdictions. The contemporary legal system in China has elements originating in overseas jurisdictions, reflecting a symbiosis of Eastern and Western civilizations, which is a pragmatic approach for developing and newly independent countries.[919]

North considers path dependence as the "constraints on the choice set in the present that are derived from historical experiences of the past,"[920] and affirms that the dominant beliefs of powerful political and economic entrepreneurs result in the accretion of elaborate institutional structures that could "impose severe constraints on the choice set of entrepreneurs when they seek to innovate or modify institutions in order to improve their economic or political position."[921]

The path is full of all kinds of institutions that are formal or informal "rules of the game in a society or, more formally, are the humanly devised constraints that shape human interactions."[922] The institutions that have been created or are evolving aim to reduce uncertainty and seek stability in social development and human behaviors.[923] North points out that institutions related to political stability, property

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[918] In history, the Chinese emperors, full of hubris, regularly treated those Western countries as barbaric and backward nations. Law was colored by politics and was further distorted from the original regulatory sense.

[919] See Emmy Saisarl, *Colonialism* (Longman, 1997), at 73-76.

[920] See North, Douglas Cecil, *Understanding the Process of Economic Change* (Princeton, N.J.: Princeton University Press, 2005), at 49. North thinks that the "institutional framework" consists of political structure that develops political choices, property rights structure that defines the formal economic incentives, and social structure that are norms and conventions, at 52.

[921] *Ibid*. at 2.

[922] *Supra* Note 748, at 3.

[923] *Ibid*. at 6.

security, and the rule of law are most important and will raise both "physical capital" and "human capital."[924]

Path dependence may have counteractive effects on radical law reform, but the adaptive selection power of a nation must not be ignored. North calls this kind of power "adaptive efficiency," and posits that it is able to restrict the influence of institutional differences between jurisdictions.[925] Moreover, private parties may also choose to resort to contracting to avoid the influence of path dependence where it is not regulated by mandatory legal rules.[926]

It is recognized that globalization is "both a cause of convergence and a measure of the degree to which convergence has occurred."[927] Globalization is already an irreversible trend, and derives from practical experience. For developing countries, convergence by means of legal transplanting may help them rapidly reconstruct legal arrangements "by the increased availability and more efficient allocation of resources, freer circulation of knowledge, and more open and competitive milieus."[928] China is increasingly linked with and affected by the impact of globalization through it extensive contact with other countries, which has deepened the understanding of international practices.[929] The motivations for legal transplanting can be classified

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[924] Roger LeRoy Miller, Daniel K. Benjamin & Douglass C. North, *The Economics of Public Issues* **(**15th ed.) **(**Boston, MA: Pearson/Addison-Wesley, 2008), at 21.

[925] See Ronald J. Gilson, "Corporate Governance and Economic Efficiency: When Do Institutions Matter?" (1996) 74 Wash. U. L. Q. 327, note 17, 18, and at 332-3.

[926] Lucian Arye Bebchuk, "A Theory of Path Dependence in Corporate Ownership and Governance" (1999) 52 Stan. L. Rev. 127, at 161.

[927] Randall Peerenboom, "Globalization, Path Dependency and the Limits of Law: Administrative Law Reform and Rule of Law in the People's Republic of China" (2001) 19 Berkeley J. Int'l L. 161, at 161.

[928] Henry J. Steiner, *International Human Rights in Context: Law, Politics, Morals: Test and Materials* (New York: Oxford University Press, 2000), at 1309.

[929] See Kanda, Hideki and Milhaupt, Curtis J., "Re-examining Legal Transplants: The Director's Fiduciary Duty in Japanese Corporate Law" (March 24, 2003). Columbia Law and Economics Working Paper No. 219. Available at SSRN: http://ssrn.com/abstract=391821, at 5,7 and 9. Kanda & Milhaupt refer to the "success

into three types: (1) passive acceptance, usually following colonization, military occupation, or political need; (2) voluntary transplanting for the purpose of "practical utility" in the domestic legal system;[930] and (3) accidental transplanting, where, in the view of Montesquieu the adaptation of specific laws from one jurisdiction to another is "accidental."[931]

B. How law reform originally and officially took place in China

It was stated by Deng Xiaoping that "a good system can lead more people to be good, and a bad system will make the good people turn bad."[932] The process of law reform in China over the past century has undergone four phases: (a) during the late Qing Dynasty[933] from 1902 to 1911; (b) during the Republic of China after the "Xin Hai Revolution"[934] based on the Kuomintang's "*Six Codes*"[935]; (c) from the establishment of the People's Republic of China (PRC) in 1949 until the end of the

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of legal transplant" that the imported legal rule is used in the same way with intended consequences as it is used in the home country. They further recognize that both "micro-fit" (the complementation of imported rules with the preexisting legal infrastructure) and "macro-fit" (the complementation of imported rules with the preexisting political and economic institutions). And they use the experience of Japan to explain that the double-fit standard is likely to take time to measure up even if the transplant was at the first start ill-fitted: the fiduciary duty was transplanted by Japan from the United States in 1950 and had never been specifically applied by the Japanese courts until the late 1980s when other specific provisions of corporate law are not able to cover the newly emerging activity and judiciary finds its ways to confer the claimant with judicial relief for the breach of fiduciary duty.

930 *Ibid*. at 7.

931 See generally Montesquieu, Charles de Secondat, Baron de, *The Spirit of the Laws* (Cambridge: Cambridge University Press, 1989). But Montesquieu never denies the possibility of transplantation, but recognizes the difficulty of achieving its original purpose.

932 See Deng Xiaoping, *Collection of speeches and Writings by Deng Xiaoping* ("*Deng Xiaoping Wen Xuan*"), Volume 2 (People Press, 1994) (in Chinese).

933 Qing (1644-1911A.D.) was the last dynasty in Chinese feudal history.

934 The "Xin Hai Revolution", lead by Suen Yi-San, overturned the reign of the Qing Dynasty and ended the feudal system in China, which had lasted for more than two thousand years (B.C. 221-1911 A.D.).

935 The "*Six Codes*" were composed of the Constitution, civil, criminal, civil procedure, criminal procedure, and administrative laws.

"Cultural Revolution"[936] in 1976; and (d) from China's adoption of the state policy known as "Reform and Opening Up to the Outside World"[937] from 1978 to the present.

From the mid-1800s, Chinese people under the imperial Qing Dynasty experienced war, invasion, and colonization. The Opium Wars (1839-1842)[938] broke the gates of China to the outside world. As a result of invasion and colonization by Great Britain, France, Russia, the United States, Portugal, Japan, and other imperialistic countries, China fell into a semi-feudal and semi-colonial state. As a "colony of many countries," the Qing imperial government was forced to sign a number of unequal treaties, according to which China had to cede land, open more trading ports, and make heavy payments to the foreign powers.[939]

In the political sense, the sovereignty of the Qing Dynasty was lost. The invading countries deprived the Qing government of state sovereignty and shared administrative power among themselves. Being conscious of the difficulties in governing such a huge country, the colonial countries made use of the Qing governments as a tool to control China. This policy was "Controlling Chinese by Chinese" ("*Yi Hua Zhi Hua*"). It was in this way that China became a semi-colonial and semi-feudal country.

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[936] The "Cultural Revolution" from the 1966 to 1976 had made retrogress and left unimaginable legislative and judicial lacunas.

[937] The state policy of Reform and Opening Up was adopted at the 3rd Plenum of the 11th Central Committee of the Communist Party of China in 1978.

[938] The War broke out as a result of Chinese attempts to halt the trade in opium, which had been a source of immense wealth to European traders in China. See also Anghie, Antony, "Finding the Peripheries: Sovereignty and Colonialism in Nineteenth-Century International Law" (1999) 40 Harv. Int'l L.J. 1.

[939] Since the first unequal treaty in China's history, that is, Treaty of Nanjing, there were a series of such treaties with Great Britain, France, Russia, Japan, etc. See also Orts, Eric W., "The Rule of Law in China" (2001) 34 Vanderbilt J. of Trans. L. 43.

From an economic perspective, the traditional agricultural society based on hierarchy and identity was challenged by industrial technology, which was based on equality and contracts. The self-sufficient economic system in China was primarily based on agriculture and a household handicraft industry of limited productivity. The highest population growth rate in China's demographic history also occurred during this period. The large population of over 400 million caused tensions over resource distribution and competition, which led to social instability and turbulence.[940] The colonialists controlled and monopolized the Chinese market by using their privileges to make unequal treaties. They dumped goods and output capital into China by setting up factories and banks, rebuilding railways, and exploiting mines, all of which had bolstered the economic system of China before the Qing Dynasty collapsed.

Against the backdrop of long-standing and time-honoured stability, colonized Qing dynasty recognized that its development lagged behind that of the rest of the world. It had tried to catch up through a succession of reforms proposed in the 1860s[941] by introducing military technology from Western countries. However, by the end of the nineteenth century, and especially after its defeat by Japan in the First Sino-Japanese War (1894-1895),[942] the Dynasty was aware that the choice between existential survival and destruction could only be solved through reform and reconstruction of the social system and its institutions.

Law reform at that time served two purposes: "to pave the way for the transition from traditional law to modern Western law; and to respond to Western criticisms on

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[940] John Finnis, *Natural Law and Natural Rights* (Clarendon Press, 1996), at 8.

[941] This reform, called "Yang Wu Campaign", focusing on learning and introducing advanced science and technology, especially on military equipments, lasted thirty years from the 1860s to 1890s.

[942] This War was a conflict between Japan and China for supremacy in Korea, demonstrating the emergence of Japan as a major world power and weakness of the Chinese Empire. At last, China agreed to pay a large indemnity and to give Japan trading privileges on Chinese territory.

the cruelty of certain penalty provisions in traditional Chinese law."[943] What is more, judicial independence was deprived and replaced by "consular jurisdiction."[944] The colonialist countries promised to return judicial sovereignty to China only if China would undergo legal reform by transplanting foreign laws. It was under such circumstances that the Qing dynasty launched a legal reform in 1902, the purpose of which was to retrieve the lost juridical sovereignty. Presided over by Shen Jiaben (1840-1913), the imperial legal commissioner, this legal reform was carried out for a decade until the fall of the Qing Dynasty in the "Xin Hai Revolution" in 1911, which brought to an end the Chinese feudal system of more than two millennia.

In terms of legislation, rather than a uniform code containing all legal provisions, the new legal system separated public from private statutes and substantive from procedural laws. More than ten statutes were drafted and promulgated in the areas of politics, economy, trade, culture, education, justice, and diplomacy. These statutes were to replace the former *"Da Qing Lü Li" Code* (*Code of Qing Dynasty*), which applied across the nation before the reform.[945] The judicial system was then transformed through the separation of adjudication from government authority. Legal

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[943] *Supra* Note 896, *Wang Jiangyu*.

[944] It is called in the other way "exterritorial jurisdiction". The colonist enjoyed the privileges and immunities that if a national of any colonist became a defendant in a lawsuit, civil or criminal, he was not to be tried by a Chinese court but by the consul of his own country.

[945] The draft of *Civil Code* was made in 1907 by Japanese jurists, on the basis of patterns copied from the civil laws of two European countries: France and Germany. The format of the Civil Code followed the German model, with the same titles and sequence of five parts: general rules; law of obligation; law of property; family law; and succession. The principles of the Civil Code derive from the main lines of the French Civil Code (1804), which was the benchmark civil code of civil law system including the classic concepts are "equality", "protection of private property", "freedom of contract", and "fault liability". The Commercial Code was also drafted by jurists from Japan in 1908, and was based on the commercial laws in Germany, Japan, Great Britain, and the United States as well. It was the first code dealing with economy in Chinese legal history, ensuring the legitimate status of private business entities.

proceedings were complemented by new rules, such as proxy and bailment. A number of new legal concepts and principles were also introduced, such as "rights and obligations," "equality," "human rights," and "separation of powers" by means of translating Western laws and legal literature, the drafting of laws by Japanese scholars, setting up legal education in schools,[946] and sending students abroad to study foreign law.[947]

The law reform launched by the Qing government did not enable it to regain legal sovereignty, retrieve its territory, and rebuild the prosperity of the dynasty. However from a historical perspective, it was undoubtedly the starting point of official law reform in China, and gained the country greater exposure to the outside world (probably accompanied by humiliation and disgrace), and constitutes the preliminary framework for the contemporary Chinese legal system.

This legal reform changed China's original self-sufficient legal system and launched China into a more advanced global system. This was a two-way process between China and the outside world, accompanied by humiliation and disgrace in addition to social transformation and progress.[948]

C. Progression of law reform in China in the past thirty years

[946] From 1897 to 1909, there were 58 Japanese professors of law in 13 law schools in China. See Fang Liufang, "Legal Education of China" (1996.2) Comparative Law Research 1(in Chinese).

[947] From 1905 till 1910, nearly one thousand Chinese students had been sent to overseas for legal education, and the destination of most students was Japan. See Philip C. C. Huang, *Code, Custom, and Legal Practice in China* (Stanford University Press, 2001), at 39.

[948] The Qing Dynasty may have no choice in history to evade being aggressed after the industrialization of the Western world. While I affirm the positive effects of legal modernization in China, I will never uphold the invasion and colonization itself.

The new Chinese government under the leadership of Deng Xiaoping began to carry out reform and opening-up policy in 1978[949] under the state policy known as "Reform and Opening Up to the Outside World."[950] Law reform since the late 1970s has contributed to the establishment in China of a modern legal system suitable for a market-oriented economy.[951]

After experiencing the "Xin Hai Revolution" (1911), "War of Liberation" (1945-1949), and Cultural Revolution (1966-1976), most of the traditional shackles fell away. After jettisoning the blind worship of the Soviet Union, the socialist government of China began to seek legal modernization. The traditional legal culture was re-examined and researched, in a process of "developing the useful and discarding the useless," from diverse legal sources. The contemporary Chinese legal system came into being in a process filled with conflict and compromises between transplanted and local institutions.

In contrast to the legal reform during the late Qing dynasty, which was a passive undertaking with the intention of utilizing legal transplants to save the country from being totally colonized by invaders, law reform in China since the late 1970s has been a spontaneous process.

Law reform played a leading part in the process of modernization in China in the 20th century, and will continue to promote this process. Law is not only a set of rules, but also a combination of thoughts, attitudes, customs, and modes of conduct.

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[949] It refers to the economic reforms under "socialism with Chinese characteristics" that were started in December 1978 led by Deng Xiaoping and are ongoing to the present. The goal of Chinese economic reform was to open China to the rest of the world in order to attract foreign investment and generate sufficient surplus value to finance the modernization of the mainland Chinese economy, available online: http://en.wikipedia.org/wiki/Economic_reform_in_the_People's_Republic_of_China

[950] *Ibid.*

[951] The reform is a milder and more practical form of social evolution rather than revolution.

Adaptability and applicability must be considered. Law reform has been a universal practice throughout history, reflecting the demands deriving from a nation's unique circumstances and its visions of the outside world.

D. Problems of law reform in China

(A) Are laws lacking in China?

The answer to the question of whether laws are lacking in China is probably negative. Since the late 1970s, China has carried out legal reform to establish a relatively complete system of law and advance legal modernization.[952]

"Legislation" is defined by Hart as "an exercise of legal powers operative or effective in creating legal rights and duties."[953] However, statutory law can never be complete. Legislation is not the only resource to be relied on in a "rule of law" society, because other factors such as morality and credit are also at work.[954] There are a few elements of company law that are common across jurisdictions. Hansmann and Kraakman (2001) identify the five essential characteristics to be legal personality, limited liability, transferable shares, investor ownership, and delegated management under the board structure.[955] The legal rules of corporation law are usually divided

[952] It is described that "bookstores in Beijing, Shanghai, and other major cities are well stocked with books on law, and crowded with prospective purchasers. Law faculties are filled to capacity with many of China's best students, driven by the prospect of lucrative employment to study a field that for all intents and purposes did not exist 25 years ago. Law firms have multiplied--more than 5,000 have been established since 1990, bringing the total to more than 9,000". See Law Society of China, *Basic Conditions of National Lawyers Work, Notary Work And Mediation Work* (2000), at 1226. See also *supra* Note 903.

[953] H. L. A. Hart, *The Concept of Law* **(**2nd ed.) **(**Oxford: Clarendon Press, 1994), at 31.

[954] Su Li, *How the Institutions Came into Shape* (Beijing University Press, 2007), at 181.

[955] *Supra* Note 34, at 439-40.

into two kinds: mandatory and enabling provisions.[956] Corporation laws should be "a continuous evolution of law to a changing environment"[957] and should have a capacity for constant adaptability in a changing society.

According to statistics, the promulgation of new legislation in China from 1979 to 2004 increased by 11.8% per year,[958] with "new laws and regulations are being issued at breakneck speed, old laws and regulations are amended continually, and whole new regulatory regimes and institutions are being created."[959] The *White Paper on China's Rule of Law* published in 2008 announced that the number of currently effective laws promulgated by the National People's Congress (National Legislature of China) as at the end of 2007 was 229.[960] Over fifty regulations have been issued by the CSRC governing listed companies and securities market.[961]

(B) Problems

The path of law reform has not been smooth or easy given the specific political, economic, and social conditions in China. Legal reform must be ongoing to catch up with the progress of political and economic reform.[962] In addition to objective demands, the legal system in China will "continue to be driven by more social sources,

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[956] See for example *supra* Note 86, at 30. The legislators should seek the balance between over-regulation of legislation and free options owned by private sector.
[957] *Supra* Note 622, at 794.
[958] Feng Yujun, "The Summary and Review of China's Rule of Law Reform over the Past Thirty Years" (2010) 108 Journal of Gansu Institute of Political Science and Law 22 (in Chinese), at 28.
[959] See Randall Peerenboom, "The X-Files: Past and Present Portrayals of China's Alien 'Legal System'" (2003) 2 Wash. U. Global Stud. L. Rev. 37. See also *supra* Note 804, at 71.(done)
[960] *Supra* Note 899.
[961] CSRC, China Securities Regulatory Commission Annual Report (2008) (China Financial & Economic Publishing House, 2008) (in Chinese), at 46-7.
[962] *Supra* Note 175, at 237; *Supra* Note 622, at 45. It is found out that "privatization typically preceded legal reforms, which would secure the control rights held by incumbents rather than protect the new title holders".

including the "Chinese citizenry's desire for justice" and international pressure on domestic business.[963]

The first problem of legal reform lies in the compatibility of the new legal elements with local circumstances. In the past 30 years, the motivation for reform in China has been voluntary and pragmatic, which is consistent with the golden rule of the reform policy set out by Deng Xiaoping that "for socialism to obtain the comparative advantage against capitalism, it shall audaciously assimilate all the other advanced achievements."[964] Law reform in China is target oriented and based on choice, and thus legislators actively select and take the best of the elements of foreign jurisdictions for domestic application.[965] There is a lack of empirical studies and convincing statistics to prove the effectiveness and efficiency of the new legal norms applied in China.

Second, transplanting has been the main approach to legal reform, and has repeatedly been one of the primary instruments in the process of China's legal modernization in various historical episodes. The transplanting approach is a gradual process of local orientation and acceptance. What has been transferred must "carefully leave untouched the essential, the unalterable, what is proper to China herself."[966] Many specific systems of foreign laws have been incorporated into Chinese law. For example, the *Law on Marine Environment Protection of the PRC* adopts the same registration system and criteria as the corresponding laws in the United Kingdom, Canada, and the United States.[967] When the *Rules on Software Protection of PRC*

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[963] *Supra* Note 726, *Randall Peerenboom*, at 531-40.
[964] Deng Xiaoping, *Collection of speeches and Writings by Deng Xiaoping* ("*Deng Xiaoping Wen Xuan"*) (Vol.3) (People Press, 1999) (in Chinese), at 373.
[965] *Supra* Note 877, at 827.
[966] *Ibid.*
[967] Ruan Jingqing, "Legal Transplant and Chinese Legislation" (1999) Ningxia Social Science 19 (in Chinese), at 26.

were drafted, laws from the United States, Japan and Australia were taken into consideration.[968]

Legal transplanting has also been applied to the law covering the corporate governance of listed companies in China, with independent directors being taken from the United States, the supervisory board from Germany, and the director's duty of loyalty and duty of diligence and shareholder's derivative action from common law jurisdictions.[969] These measures have been transplanted to solve underperformance or pitfalls in existing corporate governance.

Dolowitz and Marsh (1996) distinguish four main approaches to legal reform: (1) "copying", or using without change; (2) "emulation", or accepting a particular part rather than copying all the details; (3) "hybridization and synthesis", or combining elements from two or more countries; and (4) "inspiration", or "studying familiar problems" for "fresh thinking" about what is possible way to settle the problems.[970] Throughout the history of China's social development, the first three types have been widely applied. The legal reform at the end of Qing Dynasty in the early 1900s typically "copied" the Japanese and German legal systems; derivative action by shareholders and the duties of loyalty and diligence of directors, supervisors, and senior executives were emulated in corporate law; the supervisory board from Germany and independent directors from the United States were hybridized and synthesized into the two-tier board structure of public listed companies of China.

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[968] *Ibid.*

[969] Wang Jiangyu takes the view that the corporate laws of China "embrace a significant amount of institutions imported from foreign sources", consequently "it is difficult to identify the single most significant 'origin' country". See Wang Jiangyu, "The Strange Role of Independent Directors in a Two-Tier Board Structure in China's Listed Companies" in *Changing Corporate Governance Practices in China and Japan: Adaptations of Anglo-American Practices* (Edited by Masao Nakamura) (Palgrave Macmillan, 2008) 185-205, at 187.

[970] See David Dolowitz & David Marsh, "Who Learns What from Whom: A Review of the Policy Transfer Literature" (1996) 44 Political Studies 343, at 351.

"Inspiration" has required trial and error on the part of the Chinese government, legislators, scholars, and entrepreneurs throughout Chinese history to address practical issues.[971] In the next section, these practical issues (discussed in Chapter IV and V and summarized in 6.1.2 of this Chapter) are addressed using the "inspiration" approach to generate "fresh thinking" about possible ways to resolve the issues so that proposals can be consciously and voluntarily recognized, executed, and evaluated in practice.

E. Proposed law reforms in relation to the practical issues arising from state controlled ownership under the two-tier shareholding and two-tier board structure of state-held listed companies in China

Constant law reform could generate a "consistent and coherent" regulatory framework and define clear duties and obligations for public authorities and corporate organs to improve the corporate governance of state-held listed companies.[972] Law reform must be placed within the framework of specific historical, cultural, and social

[971] "Shang Yang Legal Reform" ("*Shang Yang Bian Fa"*, implemented in 359 B.C. for the first time and 350 B.C. for the second time) called by Bai Yang as "the only successful and splendid legal reform in Chinese history" in his book *Outline of Chinese History* could be an approach of "inspiration". Shang Yang, statesman of Qin Kingdom in the "Warring States Period" (*Zhan Guo Shi Dai*) of ancient China, was a legalist. Under the support of the then king of Qin (*Qin Xiao Gong*), Shang Yang carried out numerous reforms under his legalist philosophies in the social hierarchy, military power, moral ethics, etc. In particular, it is regulated by law that all the disputes shall be filed to the specific institution instead of being solved through private duel and that all the legal standards shall be fixed and be equally applied to all the people of Qin Kingdom. "Shang Yang Legal Reform" helped to change Qin from a backward and poor kingdom to a prosperous one with centralization of power devolved from the nobility, and to laid a solid foundation for Qin Shi Huang to establish Qin Dynasty and become the first emperor of a United China in 221 B.C. See Bai Yang, *Outline of Chinese History* (5th ed.) (Shanxi People Press, 2008) (in Chinese), at 152-4; see also William H. Mcneil & Jean W. Sedlar (edited.), *Classical China (Readings in World History* (Oxford University Press, 1970) at 78-81.

[972] *Supra* Note 210, at 18.

circumstances of China, and requires re-thinking and recognizing the historical and realistic situations of SOEs and state-held listed companies.

Although the public transaction of non-tradable shares has been gradually facilitated by the reform of the two-tier shareholding structure since 2005, state-held listed companies will continue to play a dominant role in the Chinese capital market. To eliminate, or at least reduce, the involvement and interference of government authorities in business operations and corporate governance, this thesis proposes the following reform to solve three of the five practical issues arising from state-controlled ownership. The other two issues of the infringement of minority shareholders' interests due to tunneling and the inability of minority shareholders to effectively exercise their rights to protect themselves through derivative action are discussed in the next section on law enforcement.

(A) The presence of supervisory board is redundant as its responsibilities have been taken up by independent directors or the audit committee (first issue in Chapter V)

Bhagat and Black's survey of US public companies finds no compelling evidence on the relationship between board composition and firm performance, and particularly the supermajority structure of independent directors within the boardroom. In China, there is similarly a lack of convincing empirical research to prove that a two-tier board system improves the corporate governance of Chinese public listed companies.

The improvement of internal monitoring in China is unlikely to be a one-off accomplishment, but a process of trial and error as legal reform and economic development deepen. As Robert Clark states, "much of the reform movement is based on seemingly plausible hypotheses, or a prior theorizing, but not also on serious and

methodical study of the facts . . . it may be that a future long-term rigorous empirical study will find a positive connection . . . in the interim, however, we proceed on the basis of theory and faith."[973]

The institution of the supervisory board in China is a misconception of the governance structure from Germany, and does not take into account the specific features of the Chinese institutional environment that affect the viability of the supervisory board due to its overlapping powers with independent directors and the audit committee.

The supervisory board could be removed, as its powers under the *Company Law* are in effect exercised already by independent directors and the audit committee. To be specific, a comparison of the supposed division of powers as summarized in Table 6.1 compared with that of its counterpart in other countries in Table 5.8 shows that the overseeing of directors and senior executives (Items 2-5 in the right column in Table 5.8) is already shouldered by independent directors (Item 2 in the left column in Table 6.1), and the monitoring of financial affairs and auditing of the company (Item 1 in the right column in Table 5.8) are under the powers of audit committee (Item 1 in the right column in Table 6.1). Similarly, although independent directors have unique approval rights over major related-party transactions, their right to propose to the board to appoint or dismiss external auditors (Item 3 in the left column in Table 5.8) is exercised by the audit committee (Item 2 in the right column in Table 6.1).

Table 6.1 Division of Powers between Independent Directors and the Audit Committee

Independent Director	Audit Committee

[973] *Supra* Note 690, *Robert Charles Clark*.

1. Major related-party transactions (referring to transactions that the public listed company intends to conclude with related parties and whose total value exceeds RMB 3 million or 5% of the company's net assets as audited recently) should be approved by independent directors before being submitted to the board of directors for discussion. Before the independent directors make a judgment, an intermediary agency can be employed to produce an independent financial advisory report that will serve as the basis for final judgment. 2. Providing independent opinion on the following matters to the board of directors or at the shareholders' meeting. (1) Nomination, appointment, or removal of directors. (2) Appointment or dismissal of senior executives. (3) Remuneration for directors and senior executives. (4) Current or proposing loan borrowed from the public listed company or other fund transfer made by the company's shareholders, actual controllers, or affiliated enterprises that exceeds RMB 3 million or 5% of the company's net assets as audited recently, and whether the company has taken effective measures to collect the due amount. (5) Events that the independent director considers to be detrimental to the interests of minority shareholders.	1. Monitoring the financial affairs and auditing of the company. 2. Appointing or dismissing external auditors.

An individual independent director does not have a magic effect himself or herself, but together and in cooperation they can create a structural adjustment to make the monitoring of corporate business more effective.[974] The independent

[974] John F. Olson & Michael T. Adams "Composing a Balanced and Effective Board to Meet New Governance Mandates" (2004) 59 Bus. Law. 421, at 422.

directors themselves could meet at least once a year apart from the other directors on the board to discuss and exchange views and comments on corporate affairs and the performance of duties. [975] Independence not only stands for the relationship with the company, but also indicates "independent thought," which would enable independent directors to function better as a watchdog.[976] Meanwhile, independent directors should not completely isolate themselves from non-independent directors. They should still be involved in the management activities of the company to better understanding the business and more effectively monitor transactions.

(B) Independent directors may not be able to protect minority shareholders (second issue in Chapter V)

a. Reinforcing the independence of independent directors through their nomination, remuneration, and evaluation by third parties

Currently, the appointment of independent directors must be submitted by a public listed company to the CSRC for approval,[977] and in the case of commercial banks and insurance companies must also be approved by the China People's Bank and Insurance Regulatory Committee, respectively.[978]

Some scholars also propose setting up an institution, government agency, or self-regulatory organization to be in charge of the nomination and appointment of

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[975] *Supra* Note 691, at 11.

[976] Erica Beecher-Monas, "Marrying Diversity and Independence in the Boardroom: Just How Far Have You Come, Baby?" (2007) 86 Or. L. Rev. 373, at 376.

[977] *Supra* Note 11, Art. 4(3).

[978] Art.11, *Guidelines of Independent Director and Outside Supervisor in the Joint-Stock Commercial Bank*, issued by People's Bank of China, with effect from 23 May, 2002; Art.8 of the *Interim Measures for the Administration of Insurance Companies' Independent Directors*, issued by the China Insurance Regulatory Commission, with effect from 6 April, 2007.

independent directors.[979] Chee Keong Low, Associate Professor at the Chinese University of Hong Kong, also suggests that the third party should be a government agency.[980]

In practice, since November 2009 the SASAC has acted experimentally as such a corporate governance authority for the selection and appointment of non-executive directors in some central SOEs in which it is the investor.[981] However, the SASAC is not strictly an outside third party, as it is controlling shareholder of many central SOEs and exercises investor's rights authorized by the State Council on behalf of the state. Non-executive directors appointed by the SASAC are generally retired senior executives of SOEs, professional managers of multinational corporations, and professionals and scholars in the fields of finance, law, and taxation.[982] The directors appointed by the SASAC report to the SASAC every half year unless urgent matters arise that require prompt reporting.[983]

A feasible solution for state-held listed companies in China is to confer the nomination, remuneration, and evaluation of independent directors to an outside third party (hereinafter termed the CG Authority).

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[979] See Guangdong Bureau of CSRC, "The Proposal of Improving the Supervisory Board and Independent Directors of Public Listed Company", 21 August 2008, available at: http://www.csrc.gov.cn/n575458/n870586/n8215838/10776215.html; See also Peng Dingdai, "The US Independent Director system and Reflections on China", (2007) 5 Law Review (in Chinese); Huang Feiming, "Independent Director shall contribute more to protecting the minorities", available at: http://www.chinavalue.net/Article/Archive/2008/3/1/101694_2.html

[980] Chee Keong Low, "A Road Map for Corporate Governance in East Asia" (2004) 25 Nw. J. Int'l L. & Bus. 165, at 179-80.

[981] *Regulation of Non-executive Directors in the Experimental State-owned Enterprises*, issued by the SASAC, with effect from 13 October 2009.

[982] Feng Zhenzhong, "The Reflections of the Non-executive Director System" (2008), written by the official of SASAC, available on the website of the SASAC: http://www.sasac.gov.cn/n1180/n1271/n4213364/n4213672/n4222565/4376488.html

[983] *Supra* Note 981, Art.9.

(a) Nomination

The CG Authority would be entitled to nominate qualified and technically competent independent directors from its talent pool. The selection of independent directors should be made on the basis of qualification and experience. The selected candidates must also meet the basic requirements of independence.[984] The qualifications of candidates may be further evaluated by the nomination committee of the company board for specific requirements such as shareholding and conflicts of interests. The independent directors would finally be elected and appointed at a shareholders' general meeting by the passing of an ordinary or special resolution, depending on the articles of the company. The nomination of independent directors would thus be under the authority of an outside party, so that state-held listed companies, and more exactly their controlling shareholders, would elect independent directors from a designated list of candidates only, rather than electing candidates picked for the controlling shareholders' benefit.

(b) Remuneration

In the experimental SOEs, the remuneration package (including salary, bonuses, and mid-/long-term incentives) of non-executive directors is currently determined by the SASAC.[985] It is assumed under the proposed system that the remuneration package of an independent director is composed of two parts: one part is the basic allowance decided by the CG Authority in consideration of qualifications and

[984] *Supra* Note 980, at 179-80. The author points out that "a fine balance" should be stricken: "On the one hand, they should be sufficiently broad to provide for a large enough pool and avoid micro-management that may turn away talented individuals from assuming the office of INED (non-executive directors). On the other hand, they should be sufficiently rigorous not only to ensure that those eligible are independent, but also professionally qualified to manage shareholder investments prudently and to attain a rate of return that is commensurate with the risks undertaken."

[985] Supra Note 981, Art.16 and 17.

experience, and the other is based on individual workload and corporate performance, and would be determined by the remuneration committee of the corporate board.[986] The sources of remuneration of independent directors should not be subject to approval at a general meeting. Rather, they should be extracted from special funds drawn from the annual profits of the company. This would give independent directors a more independent space in which to exercise their professional role of surveillance.

(c) Evaluation

Good governance depends on best practice in the areas of "board size, committee structure of the board, frequency of board meetings."[987] Are more and longer meetings always better?[988] More probably, effective work flow and an ethical mindset among directors are more valuable. As Burris, Kempa and Shearing state, "systems of governance can help promote rationality and fairness, but these are, in the end, characteristics of people, not systems".[989]

The appraisal of the performance of independent directors shall be conducted by the CG Authority by means of a dynamic evaluation mechanism constituting identified indicators, including, without limitation: (1) whether there have been any scandals in or sanctions imposed on the company (for example, the listed company has not been publicly censured or received any other administrative discipline by the CSRC in the past three years; (2) whether the independent director has exercised an appropriate level of professional skepticism in discharging his or her statutory duties;

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[986] *Ibid*. at 181. See also Sarah Kiarie, "Non-Executive Directors In UK Listed Companies: Are They Effective" (2007) 18(1) I.C.C.L.R. 17, at 21.
[987] *Supra* Note 86, at 38.
[988] Douglas M. Branson, "Too Many Bells? Too Many Whistles? Corporate Governance in the Post-Enron, Post-Worldcom Era" (2006) 58 S.C. L. Rev. 65, at 66.
[989] Scott Burris, Michael Kempa & Clifford Shearing, "Changes in Governance: A Cross-disciplinary Review of Current Scholarship" (2008) 41 Akron L.Rev.1, at 66.

and (3) annual ratings of corporate governance by grading agencies in the industry. The CG Authority may choose a number of indicators to adequately and appropriately appraise the quality of work performed by independent directors.

b. Might this solution run counter to the idea that shareholders should be entitled to exercise their votes to appoint whoever they want?

Under majority rule, majority shareholders can normally nominate the membership of the board unless otherwise set out in the articles of the company.[990] The articles reflect the will of corporate members, and thus "the will of the majority prevails" and "the decision of the majority will be binding on the minority."[991] In the case of public listed companies, the minority can choose to sell their shares to exit, but may resort to the courts to change the majority's decision on the grounds of prejudice or other statutory circumstances.[992]

However, majority rule cannot be pushed too far in state-held listed companies in China.[993] The danger is that the controlling shareholder will "abuse his power and enrich himself at the expense of the other shareholders."[994] Thompson points out that "an unqualified system of majority control creates the potential that a selfish majority will appropriate the interests of the minority."[995] As discussed in Chapter IV,

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[990] Robert B. Thompson, "Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law" (1995) 84 Geo. L. J. 1, at 2. The author traces the limits on the majority rule back to the American political system: "the limits on this majority power are likewise well known, beginning with the limited power of government under our Constitution and the protection of individual rights through a judiciary independent of the legislative and executive branches".

[991] See Shanthy Rachagan, "Agency Costs in Controlled Companies" (2006) Sing. J. Legal Stud. 264, at 264-5.

[992] *Ibid*.

[993] *Ibid*.

[994] See Jens Dammann, "Corporate Ostracism: Freezing Out Controlling Shareholders" (2008) 33 J. Corp. L. 681, at 685. See also *supra* Note 991.

[995] *Supra* Note 990, at 1.

tunneling by controlling shareholders' making guarantees for holding companies' loans and the diversion of corporate funds to holding companies causes loss and damage to the company and the interests of minority shareholders. What is noteworthy is that derivative claims made by the minority shareholders of listed companies are rare in China, with no judgment being found in the "LawinfoChina" database since the *Company Law* was revised in 2006. It is difficult for the courts in China to decide on derivative claims that might involve ruling against the government.

The proposed third party's authority to nominate and evaluate independent directors is an exception to the majority rule, but the need for independent directors to safeguard minority shareholders is so important, particularly in state-held listed companies, that the majority's wishes cannot be fulfilled at their will. The third role of independent directors to protect minority shareholders aims to independently monitor the controlling shareholder's conduct and to prevent corporate scandals which would damage investor's confidence in "an environment where disclosure is minimal and legal remedies are uncertain."[996]

The basis of the third role of independent directors will inevitably cause conflicts of interest with controlling shareholders. However, in state-held listed companies, the monitoring role over controlling shareholders assumed by independent directors may not be efficacious because their nomination and remuneration are firmly correlated with and influenced by the controlling shareholders. For this reason, if the entitlement of nomination, remuneration, and evaluation of independent directors could be taken over by a third party, then corporate scandals due to the majority's abuse of power could be prevented and tackled at source. Indeed, in a sense, the controlling

[996] *Supra* Note 991.

shareholder's rights under majority rule would be transferred but not deprived, to the outside third party with the benefit that independent directors would actually, rather than merely nominally, play a positive and independent role on the board.

Broadly speaking, corporate governance is not only a legal issue, but an issue of balance of power. The law plays an important role in striking a balance of power between the majority and minority. An illustration of this is the legal constraints on the ability of majority shareholders.[997] For instance, during the Reform of Sales of Non-Tradable Shares of Public listed Companies in the A-share market of China, as analyzed in Chapter IV, the proposal of each company must obtain majority approval from holders of tradable and non-tradable shares separately.

Thus, the third party's authority would run counter to the majority rule that shareholders should be entitled to exercise their votes; but independent directors would in effect fulfill their third role of safeguarding the interests of minority shareholders under this outsourcing arrangement.

(C) Minority shareholders may not be able to effectively exercise their rights to protect themselves under the cumulative voting system (second issue in Chapter IV)

Cumulative voting may well work in three ways. First, as proposed, if the nomination of independent directors were the authority of an outside party, then the controlling shareholder's votes would not be concentrated on candidates who have no relationship with them, and thus minority shareholders would have more chance to pool their votes to elect independent directors from the designated list of candidates.

The second way relates to nomination. In state-held listed companies, it is impractical for minority shareholders to elect nominees under the cumulative voting

[997] *Ibid*. at the part of "Conclusion".

system given the controlling shareholder's concentrated ownership in such companies. When minority shareholders wish to elect their own candidates, they need more shares for the election. So, if the shareholding threshold for nominating independent directors could be reduced, then even if minority shareholders held a very small number of shares compared with the total number of company shares it would be possible for them to nominate their directors.

Third, minority shareholders are usually public individual investors who have diverse views on the selection of candidates and on the business operations of listed companies. The existence of institutional investors who hold a large number of shares in a listed company may help to strike the balance between controlling shareholders and other minority shareholders,[998] except that institutional investors purchase the shares with the purpose of short-term arbitrage rather than long-term investment, and might not intend to nominate and elect their own directors to the board.

Institutional investors, particularly pension funds, life-insurance companies, and fund management companies, are at a nascent stage in China,[999] although in recent years the number of institutional investors has substantially increased. In 2007, the proportion of institutional investors in China's A-share market increased 25 percent from 2004 levels according to the statistics of CSRC.[1000] Up to July 2007,

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[998] See David H. Brown & Alasdair I. Macbean, *Challenges for China's Development: An Enterprise Perspective* (Routledge, 2005), at 40. See also A.J. Boyal, *Minority Shareholder's Remedies* (Cambridge University Press, 2002), at 75.

[999] Bernard S. Black & John C. Coffee, Jr. "Hail Britannia: Institutional Investor Behavior under Limited Regulation" (1994) 92 Mich. L. Rev. 1997, at 1999. Two possible reasons for the passivity of institutional investors in the United States are explained by Black & Coffee (1994): one is the "scale of modern industrial enterprise" because of the "separation of ownership and control"; the other is the legal limitation on financial institutions' participation in corporate governance. The second explanation could also be applied to the passivity of institutional investors of China.

[1000] Yongbeom Kim, Irene S. M. Ho & Mark St Giles, "Developing Institutional Investors in People's Republic of China", World Bank Country Study Paper (September 2003), at 1.

institutional investors directly or indirectly held 44 percent of the capitalization of the A-share market.[1001]

The economic system of China is in transition from a state-planned to a market-oriented economy, and the role of institutional investors in corporate governance in China is strictly controlled by the government. The activity of institutional investors in the market is monitored to ensure market stability. A number of regulations have been promulgated by the central government to control the number and proportion of foreign institutional investors. Qualified investors ("QFII") are entitled to invest in the Chinese markets after approval by the CRSC.[1002] A QFII applicant must have a sound financial and credit status to meet the requirements set out by the CSRC on asset scale, and must not have received any substantial penalties from the authorities in the place where the QFII was incorporated. Moreover, the jurisdiction in which the applicant was incorporated must have a sound legal and regulatory system, and its securities supervisory authorities must have signed a memorandum of cooperation and understanding with the CSRC.[1003]

With increasing capital from foreign institutional shareholders in the local markets, the cumulative voting system may work better with the involvement of institutional investors that are focused on long-term investment, as this would help to make good use of minority holdings.

6.4.3. Enforcing the law

[1001] *Ibid.*

[1002] The recent regulation is *Measures for the Administration of Securities Investment within the Territory of China by Qualified Foreign Institutional Investors*, jointly issued by the CSRC, PBOC and Foreign Exchange Bureau, with effect from September 1, 2006.

[1003] *Ibid*. Art. 6.

"Corporate governance is a process, not a state."[1004] A system itself cannot be evaluated as good or bad, but as effective or ineffective. Being listed does not mean that effective corporate governance has been achieved. The governance practices of state-held listed companies in China must move forward in parallel with developments in politics and the economy.

A corporate governance system is an amalgamation of diverse social elements in the process of respecting, protecting, promoting, and delivering business activities, and is recognized as an effective approach to promote political stability, economic sustainability, and social progress by preventing weak group from falling into the mire of corruption.

Shang Fulin, Chairman of the CSRC, states that "corporate governance is a permanent topic in the capital market and is a long-term task of the China's capital market." Corporate governance is not just a concept, but a true practice to be realized by means of robust, comprehensive, and systematic regulatory authorities that enforce the law. The enforcement of the law in China must be strengthened in two ways: fighting corruption and promoting judicial independence. These solutions can be applied to resolve the two outstanding issues raised in Chapter IV.

A. Minority shareholders' interests are infringed upon due to tunneling by controlling shareholders (first issue in Chapter IV)

Each country has its own factors, such as historical conditions, traditional customs, and social environment, that persist or change over a certain period due to internal evolution or external impacts. These factors shape the country's ideology in dealing with practical issues. No matter how insightful the policy-makers, legislators

[1004] Sir Adrian Cadbury, "Corporate Governance and Development", forward of Global Corporate Governance Forum.

and jurists, they cannot have a complete, intensive, and anticipatory understanding of the complex causal relations of a specific society; instead what they can grasp is generalized knowledge from history and abroad.

Tunnelling in state-held listed companies arises from corruption among controlling shareholders, who maintain close relationships with the government and CPC or who themselves are government agencies in charge of managing state assets. Fighting corruption is a long-term task in China. Given China's large geographical size and huge variation across regions and industries,[1005] there must be few countries that face the same magnitude of difficulties, with so large a population, so distinct a regional imbalance, so heavy a historical legacy, and so long-standing a cultural ideology, in solving so many problems within so short a period.

(A) Anti-corruption regime

The anti-corruption regime in China is governed by the *Law of the People's Republic of China on Administrative Supervision*[1006] and regulated by the Administrative Inspection Agency of the Chinese government ("Inspection Agency") at all levels. The Inspection Agency has the authority to investigate cases of corruption and refer cases of embezzlement, misappropriation, and bribery to the prosecutors pursuant to the *Criminal Law*.

However, there is another anti-corruption approach, "*Shuang Gui*," that plays a significant role in fighting against corruption in a political sense. *Shuang Gui* is

[1005] Qian Yingyi, "Reforming Corporate Governance and Finance in China", in (Masahiko Aoki & Hyung-Ki Kim edited), *Corporate Governance in Transitional Economies: Insider Control and the Role of Banks* (The World Bank, Washington D.C. 1995), at 240.

[1006] It was adopted at the 25th Meeting of the Standing Committee of the Eighth National People's Congress of the People's Republic of China on May 9, 1997, is hereby promulgated and shall enter into force as of the date of promulgation.

regulated by the Discipline Inspection Committee of CPC (DIC) under the *CPC Regulation of Investigation Work of Discipline Inspection*[1007]. *Shuang Gui* refers to the power of the Discipline Inspectors of the DIC to order a suspect to confess his or her crime at the designated place for an indefinite period before handing over the suspect to the Inspection Agency of the government and Prosecutors for legal proceedings or release without stain.[1008]

Shuang Gui is an internal investigation by the CPC of suspected officials who are CPC members. This means that all government officials who are CPC members are subject to *Shuang Gui*, after which they are referred for normal legal proceedings. Other suspects who are not CPC members are directly subject to investigation by the Inspection Agency. Actually, *Shuang Gui* is not legal in nature because detention must be authorized by laws passed by the National People's Congress or its Standing Committee.[1009] As it is not authorized by law but by the internal regulations of the CPC, *Shuang Gui* "poses a challenge to the Chinese legal system" and places corruption cases in an "extra-judicial zone."[1010] It is suggested that *Shuang Gui* be removed as a means of investigating government officials who are CPC members. Instead, corruption cases involving both CPC members and non-CPC members should follow normal legal proceedings.

[1007] It was issued by the Discipline Inspection Committee of CPC applicable to all the CPC members with effect from 1 May 1994. Available at: http://cpc.people.com.cn/GB/33838/2539632.html

[1008] *Ibid*. Art. 28(3).

[1009] *Law of the People's Republic of China on Legislation*, adopted by the 3rd Session of the Ninth National People's Congress on March 15, 2000, promulgated by Order No.31 of the President of the People's Republic of China on March 15, 2000, and with effect from July 1, 2000. Pursuant to Sec. 7 and Sec. 8(5), "compulsory measures and penalties such as deprivation of citizens' political rights and restrictions on personal freedom" shall be regulated by laws enacted by the National People's Congress or its Standing Committee.

[1010] The Financial Times, "The Case of the Chinese Mayor Who Wasn't There", available at: http://chinadigitaltimes.net, August 2009.

(B) Supervisory regime

Corporations in China perform within a "governance framework" that is structured "by the corporation's own constitutions, by those who own and fund them, and by the expectations of those they serve."[1011] An optimal supervisory regime must be reinforced to ensure the smooth operation of the systems of internal controls and to secure a "low level of corruption and high level of honesty."[1012] The strategy of an effective anti-corruption policy should be to clarify the roles and responsibilities of state-held listed companies and the CSRC to execute and maintain a high-quality supervisory regime to prevent existing or potential corruption.

a. Roles and responsibilities of state-held listed companies

The roles and responsibilities of state-held listed companies are proposed as follows:

(a) Obtain all possible relevant information and documents and make an initial evaluation and proposal of financial or credit limits.

(b) Ensure that credit limits are established and are sufficient before transactions.

(c) Submit requests to management for ad-hoc approval of potential credit excesses.

[1011] *Supra* Note 1004. See *supra* Note 989, at 44. The corporate actors shall have legitimate qualifications and responsibility for performance in the process of corporate governance, in which they exercise their capacity and capability. Burris, Kempa and Shearing think that the "human" element manifests a relationship of "trust"; otherwise people would either "refuse to engage participatory mechanisms for governance", or engage in "maximizing their own personal or their own groups' benefit". The good governance shall "create an incentive to channel individual economic effort into activities that bring the private rate of return close to the social rate of return. See also Douglass C. North & Robert Paul Thomas, *The Rise of the Western World: A New Economic History* **(**Cambridge [Eng.] University Press, 1973) at 1.

[1012] *Supra* Note 789, at 120.

(d) Ensure regular monitoring and surveillance of debtors' outstanding in respective portfolios.

(e) Promptly detect problem credit and delinquent accounts.

(f) Report the suspension of sales or contracts to delinquent accounts.

(g) Assist and co-ordinate the receipt of all necessary collateral documents.

(h) Development by the Risk Management department of the company a detailed work plan for the annual internal control and risk review.

b. The roles and responsibilities of CSRC

The roles and responsibilities of CSRC are proposed as follows:

(a) Evaluate the business and economic conditions and performance of state-held listed companies.

(b) Where appropriate and necessary, seek a source of information to facilitate the evaluation, including conducting an inspection or reviewing of financial reports.

(c) Approve ad-hoc applications for delayed reporting.

(d) Regularly monitor and review the status of delinquent companies.

(e) Inform the Inspection Agency promptly about existing or potential corruption;

(f) Work closely and support the Risk Management department of state-held listed companies in reporting and documentation.

c. Assessment criteria

With diligent monitoring, potential problems and risks can be identified and managed at an early stage. The CSRC should assess a company based on the following criteria:

(a) Business track record.

(b) Financial position, with key indicators such as equity, profitability, turnover, leverage, and liquidity.

(c) Credit grade and reports.

(d) Compliance of the company administration with internal corporate regulation and policies.

(e) Market news, including unusual changes and adverse scenarios.

d. Dos and Don’ts

The key points for fighting corruption and ensuring the good governance of state-held listed companies are summarized in Table 6.2.

Table 6.2 DOS AND DON’TS IN FIGHTING CORRUPTION

DO	DON'T
• Ensure that the company is within its authorized credit and transaction limit	• Extend unauthorized credit limits and transactions
• Conduct regular evaluations of business operations	• Rely only on personal judgment
• Immediately report potential corruption	• Assume any misconduct to be normal
• Maintain goodwill and a regular relationship with customers	• Treat customers on the basis of personal relationships
• Enforce discipline on customers to perform according to agreed payment terms	• Allow customers to develop poor and tardy payment habits
• Ensure all transactions comply fully with the requirements of the internal risk management policy and CSRC Regulations	• Transact/contract with a customer before obtaining proper internal approval

• Document all transactions with a customer	• Transact with a customer on an unofficial or informal basis

B. Minority shareholders may not able to effectively exercise their rights to protect themselves by taking derivative action (third issue in Chapter IV)

As discussed in Chapter IV, derivative claims by minority shareholders are rare occurrences in China. In the case of state-held listed companies, the difficulty for the Chinese courts is in dealing with the conflicts of interest between the state (the government as controlling shareholder) and individual (minority shareholders). It is essential for the Chinese courts to have judicial independence to decide such cases. Judicial independence in China comprises three aspects: 1. independence of the judiciary from other authorities; 2. independence of the lower courts from the higher courts; 3. independence of judges.

(A) Independence of the judiciary from other authorities

a. Problems

The People's Courts are the judiciaries of the state,[1013] and are divided into the Supreme People's Court and the local people's courts at four levels: the Supreme People's Court, the High Court, the Intermediate Court, and the District Court.[1014] Except for the Supreme People's Court at the national level, these are local courts located at the provincial, city, and county level, respectively. The four-level system of

[1013] *Ibid.*, Sec. 23.

[1014] The military courts and other special people's courts are not discussed in this thesis.

courts corresponds with the different levels of people's congresses[1015] and government (although the people's congresses and governments have one more level at the lowest level: the village level.)

In China, the National People's Congress (NPC), along with its Standing Committee, is the legislature of the state.[1016] It delegates certain legislative powers to the local people's congresses, central government, and local governments (collectively referred to as "authorized legislative agencies").[1017] The NPC and its Standing Committee have the authority to appeal the laws and regulations enacted by the authorized legislative agencies that contravene the *PRC Constitution* or the statutes enacted by the NPC. Moreover, the people's congresses at all levels are the "organs of state power" ("*Quanli Jiguan*"). Pursuant to the *PRC Constitution*, all power in China belongs to the people, and the people's congresses are the organs through which the people exercise the power of the state.[1018] The people's congresses are responsible for creating and supervising the government and judiciary.[1019]

The judiciary in China is not independent from the people's congresses in two senses. First, the presidents of court ("*Yuan Zhang*", who is in charge of the administration of the court and is the highest judge of the court) are elected by the people's congress at the same level, and the vice-presidents and other judges are

[1015] Pursuant to Sec.30 of the *Constitution of PRC*, the hierarchy of people's congresses is divided into five levels: a. National People's Congress (NPC); b. Province, autonomous region, or municipality directly under the Central Government, i.e., Beijing, Shanghai, Tianjin, and Chongqin; c. City (divided into districts), or autonomous prefecture; d. County, autonomous county, or city (not divided into districts, usually referring to updated names of urbanized counties in China), or municipal district; e. Village. The lowest two levels of people's congresses are directly elected (by citizens); the highest levels are indirectly elected - by representatives (elected by citizens).

[1016] *Supra* Note 227, Sec.58, and Sec.62.

[1017] *Supra* Note 1009.

[1018] *Supra* Note 227, Sec.2.

[1019] *Ibid*. Sec.3.

recommended by the president and further appointed (or removed) by the standing committees of the people's congresses at the same level.[1020] Second, the people's congresses have no authority to directly change any judicial decision that has been finally decided by the court. However, the people's congresses have the power to require a court at the same or lower level within the province to change its decision, because the people's congresses are authorized by the *PRC Constitution* to supervise the judiciary's activities as the organ of state power,[1021] in spite of the fact that the exercise of this supervisory power is an exceptional event.[1022]

The financial conditions of the judiciary are closely related to government: the financial budget of the judiciary (for example, the salary of judges and operational expenses of the courts) are calculated by the local government at the same level to be submitted to the people's congress at the same level for approval.[1023]

b. Proposal

In principle, the implementation of judicial justice in China should not be connected with or influenced by the people's congresses (legislature and organ of state power) or the government (executive branch). In practice, the personnel (election, appointment, and removal of judges) and finance (financial budgets for judges and courts) of the judiciary should be conferred by law to the Supreme People's Court so

[1020] Sec.35, *Organic Law of the People's Courts of the People's Republic of China*, passed by the Second Session of the Fifth National People's Congress on July 1, 1979 and revised on 31 October, 2006.
[1021] *Supra* Note 227, Sec.3.
[1022] In 2003, the case decided by Intermediate People's Court of Luoyang, Henan Province concerning the application of *Seed Law* was challenged by the People's Congress of Henan Province. See *Zhang Mingjie (edited), Judiciary Reform in China – Retrospects and Prospects* (Social Sciences Academic Press, 2005) (in Chinese), at 143-4.
[1023] See Tan Shigui & Li Rongzhen, *Judiciary Reform from the Perspective of Rule of Law* (Law Press, 2007) (in Chinese), at 119.

that the judiciary is virtually able to independently operate from the people's congresses and government at all levels.

With respect to the supervisory power conferred by the *PRC Constitution*, the people's congress should not require the courts to change their decisions. Instead, any local people's congress may give their comments on a judicial case decided by a court at the same level to the High Court at the provincial level or by the NPC to the Supreme People's Court for consideration.

(B) Independence of the lower courts from the higher courts

a. Problems

Pursuant to the *PRC Constitution*, the Supreme People's Court supervises the administration of justice by the local people's courts at various levels, and the courts at higher levels supervise the administration of justice by those at lower levels.[1024]

No court is independent from the Supreme People's Court and the courts at higher levels, as these have supervisory authority conferred by the *PRC Constitution*. This authority specifically refers to the following two systems within the judiciary.

(a) Instruction-request system ("*Anjian Qingshi Zhidu*")

Under the instruction-request system, the lower court can consult a higher authority and decide a case as indicated by the instructions of the higher authority. This system renders the appellate jurisdiction useless, because the first instance court may decide cases based on instructions from the higher authority rather than on its independent judgment. In practice, the Supreme People's Court delivers numerous

[1024] The Supreme People's Court is the highest appellate court in China. *Supra* Note 227, Sec.127.

instructions on cases at the request of the lower courts each year.[1025]

(b) Jurisdiction-transfer system ("*Guanxiaquan Zhuanyi*")

The procedural laws provide that the courts at higher levels can transfer a case over which it has jurisdiction in the first instance to a court at the lower level for adjudication. The courts at higher levels also have the authority to adjudicate cases over which the lower court has jurisdiction by law.[1026]

b. Proposal

It is proposed to abolish the instruction-request system, because the lower courts can resort to the instructions of higher court from time to time and the higher courts have discretion to interfere in the decisions of the lower courts. It is essential to separate the lower courts from the higher courts in delivering substantive findings. The higher courts should only overrule the decisions of lower courts through appellate procedures.[1027]

The transfer of jurisdiction may still take place in circumstances of complex factual scenarios, change of disputed amount, or avoidance of conflicts of interest in practice. The specific circumstances for transferring jurisdiction between the higher

[1025] For example, "Reply to the Issue on Loans between Individuals and Enterprises", requested by High Court of Hei Long Jiang Province, 13 February 1999; "Reply to the Issue on Litigation Arising out of Delisting", requested by High Court of Shanghai, 17 July, 2007; "Reply to the Issue on Jurisdiction on the dispute of arbitration clause", requested by High Court of Shandong Province, 8 August, 2000.

[1026] Sec.39, *Civil Procedure Law of PRC* (revised 2007), with effect from 28 October 2007; Sec.23, *Criminal Procedure Law of PRC* (revised 1996), with effect from 17 March 1996; Sec.23, *Administrative Procedure Law of PRC*, with effect from 1 October 1990.

[1027] In China, the party(ies) owning a right of appeal is entitle to appeal to the higher level court (unless the Supreme People's Court is the court who makes the judgment of first instance). The appellate court has the ***final*** adjudication power in China. It is named as "system of a court of 'second instance being of last instance'" ("*Liangshen Zhongshenzhi*")

and lower courts shall be further stipulated by laws and regulations, such as how "complex" the facts and how much a percentage change in the disputed amount would warrant a transfer.

(C) Independence of judges

a. Problems

The *PRC Constitution* expressly provides that "the courts exercise judicial power independently and are not subject to interference by any administrative organ, public organization or individual."[1028] However, "independence" refers to the collective independence of courts, rather than the individual independence of judges.[1029] Judges are not independent as a consequence of the operations of two schemes within the Chinese courts.[1030]

(a) Approval by the president of the court

In China, every judgment document issued by the court must be internally reviewed by the president of the court (or failing the president, the vice-president in charge or president's alternate). After the president's review and approval, the document is sealed by a stamp of court and delivered to the relevant parties; otherwise it has no legal force or effect.[1031]

(b) Judicial committee ("*Shenpan Weiyuanhui*")

[1028] *Supra* Note 227, Sec.126.
[1029] *Supra* Note 1023, at 117. See also Li Lin, *Rule of Law and Judiciary Reform* (Social Sciences Academic Press, 2008) (in Chinese), at 88.
[1030] *Supra* Note 1023, at 95.
[1031] *Supra* Note 1029, *Li Lin*, at 88.

In the event that the judge has found that the case that he or she is hearing is "important ("*Zhong Da*"), complex ("*Fu Za*"), or hard ("*Yi Nan*") cases (which are not statutorily defined by virtue of law but decided by the judges depending on the facts and circumstances of the case), he or she can submit the case to the judicial committee of the court to decide. In China, each court has a judicial committee that is composed of the president, division chiefs, and experienced judges.[1032] The decision of the judicial committee must be followed by the judge, although what the members of judicial committee have discussed regarding the case is confidential.[1033]

b. Proposal

The internal procedures for approval of the president of judgment documents and submission to the judicial committee for deciding important, complex, or hard cases in effect deprives judges of their independence in deciding cases based on their own knowledge and competence.[1034]

However, judges are also likely to escape or shift their responsibility in important and complex cases.[1035] This also relates to the system of misjudged cases ("*Cuo An*

[1032] "The judicial committee is the most authoritative body in a court, which is responsible for discussing important or difficult cases, making directions concerning other judicial matters and reviewing and summing up judicial experiences. In case of differing opinions, the majority's opinions shall be adopted." See "China's Judicial System: People's Court, Procuratorate and Public Security", available at: http://www.olemiss.edu/courses/pol324/chnjudic.htm

[1033] *Supra* Note 1029, *Li Lin*, at 88.

[1034] *Ibid*. at 84. See also Jiang Bixia, "Strengthening the Function of Court", People's Court Daily, 18 September 2002.

[1035] *Supra* Note 1023, at 95.

Zeren Zhuijiu Zhi") established in the courts by the regulations of each province.[1036] Where a judge is found to decide a case attributable to misapplying the substantive law or procedural law because of his or her willful misconduct or gross negligence, the case in question is determined as a "misjudged case." The hearing judge of the misjudged case is then liable and his or her salary, benefits, and promotion prospects will be substantially affected.[1037] Thus, judges may be willing to give up their independence to decide a case by resorting to the judicial committee for a final decision.

It is proposed to abolish the internal procedures for approval by the president of judgment documents to improve the independence of judges by restoring the legal effect of a judge's signature. The functions of the judicial committee should be modified so that it can give its opinion on important, complex or hard cases, but the judge hearing the case delivers the judgment.

(D) Summary

An anonymous judge in an intermediate court of China once said that he has the courage to bear the legal liability, but not the political responsibility; because the consequences of the former are expressly provided by law, whereas those of the latter are not predictable."[1038] It is essential for the Chinese courts to have judicial independence to accept and decide cases without any external political or economic

[1036] Since the 1990s, the people's congresses of a number of provinces have promulgated regulations in relation to the misjudged cases to fight against the corruptions in the judiciary. For example, the *Provision of Liability in the Misjudged Cases*, issued by People's Congress of Hainan Province, with effect from 26 September, 1997; and the *Provision of Liability in the Misjudged Cases*, issued by People's Congress of Inner Mongolia Autonomous Region, with effect from 22 June, 2006.

[1037] *Supra* Note 1029, *Li Lin*, at 88.

[1038] *Supra* Note 1022, at 42.

interference in three aspects: 1. the independence of the judiciary from other authorities; 2. the independence of the lower courts from the higher courts; and 3. the independence of judges. In China, where the rule of law has not been implemented, judicial independence depends, in addition to the aspirations of the courts and judges themselves, greatly on the social and political maturity of the political authorities to respect to the judiciary.

6.5 Conclusion

The improvement of corporate governance in state-held listed companies cannot solely depend on a few outstanding experts and elite, but should be accomplished through the contribution of all Chinese people across the generations, which will be a time-consuming and labour-intensive task. What is needed is for everyone to contribute their creative potential to conquer the obstacles on the path toward the rule of law. Although it is unlikely that there exists one perfect strategy for application in China, the most populous country in the world, a creative re-thinking and a better realization of the significance of corporate governance regimes is occurring, which should gradually move toward better protection for disadvantaged minorities and more efficient business operations in China.

Taking all the practice issues and social underpinnings (including the political challenges, economic reform, and cultural inheritance) into consideration, the following conclusions are drawn. First, state-controlled listed companies would be better governed under a "law-controlled model" rather than a "state-controlled model." This new model would improve the corporate governance of state-held listed companies by virtue of implementing the rule of law in China (or at least the "thin" rule of law in transition from "rule by law"). Failing that, the practical issues arising

from “state-controlled model” could be addressed by (i) reforming the laws; and (ii) enforcing the laws (including improving the anti-corruption supervisory regime and effecting judicial independence). To strike a consistent balance between political force and legal enforcement, the corporate governance of state-held listed companies would gain vitality if it were deeply rooted in a law-controlled model.

Chapter VII Final Reflections

> "It is not an accident that human beings preserve and advance in the face of adversity. Adaption is in our nature, a fact that leads me to be deeply optimistic about our future."
>
> Alan Greenspan "The Age of Turbulence" (2007)

This thesis addresses the issue of state-held listed companies in the context of China, which is governed by the "state-controlled model." The research was carried out using a variety of methodologies, including historical, comparative, literature, and case study analysis to examine areas ranging from economic reform to the rule of law, from path dependence to legal transplanting, from legislation to enforcement, and from government roles to market forces.

Ensuring equal access to justice is a very basic tenet across the world. In a public sense, governance is "the management of the course of events in a social system," which is an "adaptive social process."[1039] Corporate governance deals with elements in the private sector to "achieve effective and efficient management." [1040] Consequently, the corporate governance process is just one part of an overall complex of integrated legal processes that form the lifeblood of a modern industrialized society.

In the past decade, a growing number of Chinese entrepreneurs have proved willing and eager to improve corporate governance. [1041] A large number of international organizations are helping China to promote economic growth and reduce poverty. The Asian Development Bank (ADB) and International Finance Corporation

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[1039] *Supra* Note 989, at 64.
[1040] *Ibid.* at 10.
[1041] *Supra* Note 722, *International Financial Corporation*. It is concluded by IFC from its experience in the technical assistance for corporate governance in China.

(IFC) are playing positive roles in expanding employment opportunities and improving management performance.

Since joining the ADB in 1986, China has received financial loan assistance of USD 19.25 billion, ranking the country as the ADB's second largest borrower for private sector financing.[1042] The main financing projects are in the areas of urban construction, the environment, and energy-related development. A technical assistance special fund from the ADB was initiated in September 2007 aiming to improve corporate governance practices in the Bank of China.[1043] The IFC's support to China has focused solely on corporate governance in the private sector. The IFC not only provides financial assistance to the private sectors, but also takes an equity stake in corporations so that it can contribute its international expertise to help localize well-established practices from overseas, such as financial accounting and internal control systems.[1044] The current financial and technical assistance provided by the ADB and IFC is mostly directed toward small and medium-sized enterprises. Public listed companies, and particularly state-held listed companies, do not have access to such assistances due to considerations of commercial confidentiality and national security.

Focusing on development in China from a global perspective engenders a clearer understanding of the governance structure in this rapidly developing country. As a wise man once said, "in history lies the knowledge, in knowledge lies the answer." This thesis explores the problems with governance in China with respect to tunneling by controlling shareholders, minority shareholder protection, and the conflicting functions of independent directors and supervisors. The corporate governance system

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[1042] *Supra* Note 850.
[1043] *Ibid.*
[1044] *Supra* Note 722, *International Financial Corporation*.

now plays and will continue to play a key role both macroscopically in economic growth and microscopically in business expansion, and we academics should step forward to do more than we have done so far.

Above all, preaching pure rights or liabilities without considering all of the specific factors is unrealistic. The rule of law in China combines the issues of efficiency and equity because the Chinese government is pursuing socialism and depends on a policy of harmonization to strike a balance between the interests of stakeholders.[1045] All developing countries face the challenges of globalization, without completely entering into an industrialized society with free trade coupled with sound regulations. They are confronted with the threats from globalization, and at the same time the impacts of localization.

The state-controlled model has common elements with the bank-based model in an unstable securities market without timely market regulations, and is also characterized by employee participation from the stakeholder model.

One of the main future challenges is whether and how political power in China will be decentralized from the central and to the local level of government, and the level of economic autonomy that will be achieved between government and enterprises. Further, the realization of the rule of law in China may be challenged by its tardiness in reaching political maturity. The "peculiar entrenchment" of the CPC in the political system makes it impossible to apply the law to "all segments of the society," and the law is used as a "tool" by some CPC members to manipulate for the purpose of corruption.

The other challenge is choosing the empirical tools to apply and the means of

[1045] *Supra* Note 169, at 507.

applying them.[1046] Estimating the effects of the structure, inter-relationships, and functions of governance requires a systematic quantity and quality analysis of data from public listed companies. More importantly, the data must be accessible and accurate, which signifies that company operations and judicial decisions must be open and transparent for reference.

"Globalization brings not only the material forces, but also life chances of individuals and communities."[1047] Such gains are ensured by advancements in democracy and the rule of law that prevent weak group from falling into the mire of corruption and dictatorship. "Poverty anywhere constitutes a danger to prosperity everywhere."[1048] Although a complicated and long-term process, law reform in China no longer involves the direct copying and translation of legal terms, but the adaptive selection of legal concepts that suit local circumstances.[1049] Law reform must be placed within the framework of the specific historical, cultural, and social circumstances in China. Looking ahead, corporate governance systems are being adjusted by enterprises themselves under the administration of governments. The elements of corporate governance that are regulated by statutes or recommended in best practices in a jurisdiction are likely to be transferred to other jurisdictions, but not without adaption and localization.

Rather than the state-controlled model, this thesis proposes that corporate governance in state-held listed companies would work better under a law-controlled model, which is based on the progressive pursuit of the rule of law. How the ownership structure and board structure are to be made effective and efficient to

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[1046] *Supra* Note 989, at 8.
[1047] David Held *et al.*, *Global Transformations: Politics, Economics and Culture* (Stanford, Calif.: Stanford University Press, 1999) at 1.
[1048] Ben Ruth, "Social Security in the Year 2000: Potentialities and Problems" (1995) 16 Comp. Lab. L.J. 139 at 140.
[1049] *Supra* Note 877, at 827.

promote corporate governance will be decided by trial and error during the political and social transformation of China that must take place to match its economic growth.

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SPEECH

Mr. Hu Jintao, President of PRC

Mr. Wen Jiabao, Premier of the State Council of PRC

Mr. Li Ruogu, Vice President of People's Bank of China

Mr. Li Rongrong, Chairman of State-owned Assets Supervision and Administration Commission of the State Council of PRC

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